HEARING ON CHINA'S SHIFTING ECONOMIC REALITIES AND IMPLICATIONS FOR THE UNITED STATES

HEARING

BEFORE THE

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

ONE HUNDRED FOURTEENTH CONGRESS
SECOND SESSION

WEDNESDAY, FEBRUARY 24, 2016

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UNITED STATES-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

WASHINGTON: 2016

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

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); as amended by the Carl Levin and Howard P. "Buck" McKeon National Defense Authorization Act for Fiscal Year 2015, P.L. 113-291 (December 19, 2014) (regarding responsibilities of the Commission).

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

April 06, 2016

The Honorable Orrin Hatch
President Pro Tempore of the Senate, Washington, D.C. 20510
The Honorable Paul Ryan
Speaker of the House of Representatives, Washington, D.C. 20515

DEAR SENATOR HATCH AND SPEAKER RYAN:

We are pleased to notify you of the Commission's February 24, 2016 public hearing on "China's Shifting Economic Realities and Implications for the United States." The Floyd D. Spence National Defense Authorization Act (amended by Pub. L. No. 113-291) provides the basis for this hearing.

At the hearing, Commissioners received testimony from the following witnesses: Mr. Michael Turner, Executive Vice President, Mars & Co.; Dr. Jason M. Thomas, Managing Director and Director of Research, Carlyle Group; Mr. Paul Hubbard, Sir Roland Wilson PhD Scholar at the Crawford School of Public Policy, Australian National University; Dr. Wentong Zheng, associate professor of law, University of Florida Levin School; Dr. Roselyn Hsueh, assistant professor of political science and Asian studies, Temple University; Mr. Terrence Stewart, managing partner, Stewart & Stewart; Mr. Jeremy Haft, cofounder and partner, Caracal Strategies; CEO, Safe Source Trading; Mr. John Ferriola, CEO, Nucor; Mr. Alan H. Price, partner, Wiley Rein LLP; Dr. Adam Hersh, visiting fellow, Columbia University; Dr. Gary Clyde Hufbauer, senior fellow, Peterson Institute for International Economics; and Mr. Bernard O'Connor, trade lawyer, NCTM. This hearing addressed recent economic trends from a market participant perspective; assessed the role of state-owned and state-backed firms in China and abroad; examined the causes and extent of China's overcapacity problem, and impacts on U.S. and global firms and markets; and evaluated China's non-market economy status in order to inform deliberations ahead of December 2016, when certain provisions regarding China's treatment under the terms of its WTO accession protocol expire.

We note that prepared statements for the hearing, the hearing transcript, and supporting documents submitted by the witnesses are available 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 2016 Annual Report that will be submitted to Congress in November 2016. 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, Anthony DeMarino, at (202) 624-1496 or via email at ADeMarino@uscc.gov.

Sincerely yours,

Dennis C Shea

Hon. Dennis C. Shea
Chairman

Carolyn Bartholomew

Carolyn Bartholomew
Vice Chairman

CONTENTS

WEDNESDAY, FEBRUARY 24, 2016

HEARING ON CHINA'S SHIFTING ECONOMIC REALITIES AND IMPLICATIONS FOR THE UNITED STATES

Panel I: Recent Trends in China's Economy

Panel II: China's State Capitalism in the Global Context

Panel III: Overcapacity and Global Markets

Panel IV: Evaluation of China's Nonmarket Economy Status

HEARING ON CHINA'S SHIFTING ECONOMIC REALITIES AND IMPLICATIONS FOR THE UNITED STATES

WEDNESDAY, FEBRUARY 24, 2016

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Washington, D.C.

The Commission met in Room 337 of Hall of the States, 444 North Capitol Street NW, Washington, DC at 9:00am. Commissioners Robin Cleveland and Michael Wessel (Heating Co-Chairs) presiding.

OPENING STATEMENT OF COMMISSIONER ROBIN CLEVELAND HEARING CO-CHAIR

HEARING CO-CHAIR CLEVELAND: Good morning. Welcome. Welcome, Mr. Turner. In my well-prepared staff draft statement, there are a lot of details about the next Commission hearing. I encourage you all to look at them and look at the Commission's website for any details on the hearings going forward.

Today, we're going to talk about the Chinese economy and where our witnesses see it going from here. I think as China's growth slows and debt-to-GDP ratios grow to troubling levels, all in a context of problems in the banking system, there's an argument to be made that China's economy is reaching a tipping point. Many believe that heavy investment-led growth, which has also led to overcapacity, is not sustainable, so the leadership's emphasis necessarily must be on increasing productivity and consumption.

The question in my mind is if there is a sustained level of 40 percent investment rates, what will it look like going forward? Will it focus on logistical capacity that improves consumption or will it subsidize failing enterprises?

I'm also interested in how the government will think about and pursue stabilization of the banking sector, but I think the good news for the government is since almost all public and private debt appears to be denominated in renminbi, they may not need to use their reserves to recapitalize the banks.

So there are many, many questions, many scenarios, that I hope we will consider today from nonperforming loans, exchange rate depreciation, the real estate potential bubble, the commodities market, the volatility in the stock market, but ultimately the role the government will play in managing both expectations and policy, and it all needs to be assessed in the context of China's upcoming nonmarket economy status.

We have a great series of witnesses to speak to these issues, but before we turn to Mr. Turner's testimony, and hopefully Dr. Thomas', I'd like to turn to my colleague, Mr. Wessel, for his opening remarks.

PREPARED STATEMENT OF COMMISSIONER ROBIN CLEVELAND
HEARING CO-CHAIR

Hearing on China's Shifting Economic Realities and
Implications for the United States

Opening Statement of Commissioner Robin Cleveland
February 24, 2016

Good morning, and welcome to the second hearing of the U.S.-China Economic and Security Review Commission's 2016 Annual Report cycle. I want to thank you all for joining us today, especially those of our witnesses who traveled across the world to be here. We appreciate your attendance and we encourage you to attend our other hearings throughout the year.

The Commission's next hearing on March 10 will examine China's relations with South Asia. Future hearing topics this year include Assessing the U.S. Rebalance to Asia and China's Thirteenth Five-Year Plan. More information about the Commission, its annual report, and its hearings is available on the Commission's website at www.USCC.gov.

As China's economic growth slows, imbalances resulting from decades of repressed household consumption, distorted incentives, export- and investment-led growth, and regional fragmentation have given rise to economic volatility in China and abroad. In pursuing a more sustainable growth model, China's economic planners are struggling: officials have publicly stated a desire to let the market play a more decisive role in the economy, but continue to interfere with market operations to avoid the costly and destabilizing adjustments of rebalancing.

Today's hearing will seek to assess the tension between the roles of the state and the market in China's economy and the resulting impact on U.S. firms and the U.S. and global economy. This hearing will also seek to evaluate the legal and economic considerations in deliberating China's nonmarket economy status ahead of the December 2016 expiration of a key provision in its WTO accession agreement.

To help us better understand the complexities of these critical issues, we are joined by a number of experts from business, industry, legal, and academic fields. We look forward to hearing from each of you.

Let me now turn to hearing co-chair Commissioner Michael Wessel for his opening remarks.

OPENING STATEMENT OF COMMISSIONER MICHAEL WESSEL HEARING CO-CHAIR

HEARING CO-CHAIR WESSEL: Thank you, Commissioner Cleveland, and good morning. I thank everyone for being here.

Today's hearing comes at an important time. Events in China--economic, security and otherwise--are in the news. Indeed, economic events in China are increasingly seen as having a clear and direct impact on the lives of average Americans.

Workers in a variety of industries in past years have understood the impact of China's industrial policies, but now average investors are learning about the impact of China's slowing growth and stock market problems on their own economic situation.

In April, when the next round of quarterly 401(k) statements land in mailboxes across the country, many will wonder what's going on and what, if anything, can be done. And, of course, China is increasingly in the news as the election approaches.

Today's hearing will start with an analysis of key trends in China's economy. Chinese officials have touted a market-oriented reform agenda for years and have promised to loosen the government's grip on some fundamental economic mechanisms. But as demonstrated by repeated and massive government interventions to protect its stock market and defend its currency, we have to question whether the Western view of what "reform" means is what China means. We may be talking past one another.

A key issue is what's happening in China's state sector. The hearing will examine what changes, if any, are occurring in the ownership structures and activities of state-owned firms domestically and abroad, and state-owned enterprise reform, and state capitalism across sectors of varying strategic importance to the Chinese government.

The hearing will also examine China's overcapacity problem, which was originally designed to boost employment, exports and economic growth. While overcapacity initially sustained China's economy and pricing and market advantage, these policies have distorted resource allocation and diverted investments from productive uses, causing injury to the global economy.

In steel, for example, China's excess capacity, measuring upwards of 400 million metric tons, is driving down global prices and being dumped in importing markets at the expense of hundreds of thousands of laid off U.S. workers and the closure of U.S. steel mills.

Aluminum is following suit. Without an appropriate way to dismantle China's excess capacity and defend against China's unfair trading practices, losses will continue to build.

Our expert witnesses will also help establish the extent of Chinese government control over key elements of its economy, an essential piece of the debate about whether China should be granted market economy status, as Commissioner Cleveland noted, which will occur in December of this year, when a provision, a specific provision of China's protocol of accession expires.

This issue holds critical implications for U.S. firms, industry, consumers and trade remedies, as well as for the global economy.

We will also hear testimony from experts on the first two panels before adjourning for a lunch break at noon. After lunch, we'll reconvene in this room at 1:00 p.m. for the final two panels, which will focus on the impact of China's overcapacity problem and the evaluation, as I said, of China's NME status.

I'd like to thank the Commission's staff for all their help, especially Lauren

Gloudeman, for her contributions organizing this hearing, and Lauren will be leaving us shortly, unfortunately, to go on to other endeavors. We wish her well.

PREPARED STATEMENT OF COMMISSIONER MICHAEL WESSEL
HEARING CO-CHAIR

Hearing on China's Shifting Economic Realities and
Implications for the United States

Opening Statement of Commissioner Michael Wessel
February 24, 2016

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I'd also like to thank Commission staff member Lauren Gloudeman for her contributions to organizing this hearing.

I'll now begin with an introduction to our first panel this morning.

PANEL I INTRODUCTION BY COMMISSIONER MICHAEL WESSEL

And let me quickly introduce the first panel. Today we'll start by looking at key indicators, risks and imbalances in China's economy, as well as future expectations. We will hear perspectives from two seasoned business and investment leaders on what trends these indicators show and what those trends mean for the U.S. and global economies and-- welcome, Dr. Thomas.

Commissioner Cleveland and I in discussing this first panel wanted to have market participants and market advisors, those who are taking issues out of the clouds and putting them on the tables of CEOs, investors, et cetera, because money has a way of helping guide decisions, and the two people before us are market players, and we appreciate their being here.

First, Mr. Michael Turner, who serves as Executive Vice President at global consultancy Mars & Co, where he leads the firm's America's Operations. In his more than 25 years with the company, Mr. Turner has helped top management of numerous Fortune 100 companies, corporations, in automotive, consumer goods, retail, and financial sectors, among others, across North America, Latin America, Europe and Asia.

Mr. Turner graduated from the University of Pennsylvania Dual-Degree Management and Technology Program, in 1989, receiving a Bachelor of Science from the Moore School of Electrical Engineering and a Bachelor of Science in Economics from Wharton School of Business. Thank you for being here.

Second, we have Dr. Jason Thomas, the Managing Director and Director of Research at the Carlyle Group here in Washington. At Carlyle, his work focuses on economic and statistical analyses of the Carlyle portfolio, asset prices and broader trends in the global economy.

Mr. Thomas' research helps to identify new investment opportunities, advance strategic initiatives and corporate development, and support Carlyle investors.

Prior to joining Carlyle, Dr. Thomas, was Vice President for Research at the Private Equity Council. He previously served on the White House staff as Special Assistant to the President and Director for Policy Development at the National Economic Council.

Mr. Thomas received a B.A. from Claremont McKenna College, and an M.S. and Ph.D. in finance from George Washington University.

Thank you, both, for participating in today's hearing. Each witness will have seven minutes roughly to deliver his oral statement, and after that, we will engage in Q&A, and your statements will be made part of the record.

Mr. Turner, please begin.

OPENING STATEMENT OF MR. MICHAEL TURNER
EXECUTIVE VICE PRESIDENT, MARS & CO.

MR. TURNER: Terrific. Thank you. Good morning. I'm Mike Turner with Mars & Co, a global strategy consulting company. I work with many clients who have activities in Asia and in China, in particular. And what I'm going to share with you today are perspectives from work that we've done with our clients in China, and it's important that I note that we're not economists and therefore what I share with you is our practical view of the issues our clients are facing in China today and what they may be tomorrow.

So with that backdrop, I thought what I would do is--there's no chance for me to get through all of the material in the written document--I've summarized some of the key themes that I wanted to highlight.

First, if we go back through the history of the Chinese economy, it's very clear that the economy has been driven over time by what we call successive surges of investment. In the early part of the time frame, 2000 to 2007, there was an initial surge of investment that led very quickly to a surge in exports, which became a significant driver of the economy.

In that time frame, we also saw very significant productivity growth, and that was driven by the mass migration of labor into the industrial areas, whether it was the Pearl River Delta or the Shanghai area, Beijing, et cetera, and so that early period was a very robust period for the economy. Fast forward to 2008, 2009, with the global recession, we did see obviously a falloff in demand for Chinese exports, and the response of the government was to enact the stimulus that led to another surge of investment, which really has brought us to the levels that we see today – with investment representing a very significant chunk of the GDP of the economy.

And so today what we see is an investment- driven economy, still today, despite the talk of moving to a consumption-led economy, and importantly, and this was already mentioned, that investment is driven by debt and fueled by debt with debt having risen from 150 percent of GDP roughly back in 2007 to over 280 percent by the last figures that we have, and I'm sure it's higher today, just having read the most recent news on the levels of debt that are continuing to be introduced into the economy.

Okay. So that's the backdrop. Now at the same time that we see this happening from an investment perspective, the fundamental competitiveness of China's manufacturing sector has gone through its own seismic shifts. Back in 2012, '13, '14, we saw very significant levels of inflation in some of the key manufacturing regions. That led manufacturers in those areas to look for other sources of manufacturing capability in Southeast Asia, outside of China, so we saw some outsourcing of labor-intensive activities happening among the manufacturers

We also saw a renewed push for investment, but that investment really was intended to drive labor out of the equation and to drive productivity in those very labor-intensive activities. So that really reinforced some of the dynamics that were already there in the sense that we're now still seeing the requirement for investment, but this time it's to retool some of the existing manufacturing capability.

Secondly, this dynamic is having an effect obviously on employment and the need for the government to shift employment into other sectors, whether it's services or otherwise.

And then finally, this dynamic in the manufacturing sector has also contributed to diminishing surpluses in the current account. Okay. So those things are reinforcing some of the imbalances that we see, and the imbalances that we see at this point really are four critical ones:

First, and this was mentioned as well, excess capacity. I'll come back to that one.

Second, we see a real estate or potential real estate bubble emerging.

Third, we see the potential and - really the emerging signs of – a banking crisis.

And then, finally, we obviously have seen the depletion of the foreign exchange reserves that have been a bulwark against what was happening in the rest of the world for China.

So those imbalances are all important imbalances that are structural issues that need to be solved. The first one, the excess capacity, is the one that is an issue everyday for our clients, whether it's related to their global business or whether it's related more specifically to activities in China, and it takes a couple of forms. Where our clients are participating in global sectors, this excess capacity obviously finds a home in markets like here or in Europe.

Where our clients are facing excess capacity domestically in China, that is really creating problems for our clients in thinking about whether they want to stay in the market. If they've put fixed assets into a market and they're facing excess capacity and price pressures, they're facing existential issues about whether they want to stay.

So those are the two aspects of excess capacity that are affecting our clients. So what are we telling our clients? Well, we're telling them a couple of things. First, we're saying plan for a number of eventualities, and in the document that we've shared today, we've laid out a couple of scenarios that we in the course of our work are helping our clients think through. So plan for a number of eventualities because it's still a work in process.

Second, what we're suggesting is that you have to pay attention almost everyday because the actions that are being taken are happening everyday, and so pay attention everyday. What we see is that certainly the stated intentions sound right. What we've experienced, though, is some of those stated intentions, even going back into history, don't materialize into real actions, and so what we're telling our clients to do is to really pay attention to where real action starts to happen, and that is a stronger signal of real change than just the talk.

So those are the things we're telling our clients: pay attention to what's being said and documented day to day. And then finally we're saying, look, in the domestic economy, there is hope. The consumer is a very robust consumer. They've lived through one of the greatest booms in history, and they're very aspirational, and so any of our clients who have consumer activities going on in the market, there is opportunity there, and that opportunity is with that kind of younger millennial consumer and is also increasing in the remote cities in tier two, tier three, tier four cities in China.

That is the summary of what I wanted to talk through. There's a lot more detail in the document that we've shared, and we can talk about that in the Q&A. Thank you.

HEARING CO-CHAIR WESSEL: Thank you.

Dr. Thomas.

PREPARED STATEMENT OF MR. MICHAEL TURNER EXECUTIVE VICE PRESIDENT, MARS & CO.

February 24, 2016
Michael B. Turner
Executive Vice President, Mars & Co
Testimony before the U.S.-China Economic and Security Review Commission
Hearing on China's Shifting Economic Realities and
Implications for the United States

Caveat

This document contains observations and analyses regarding China's economy as they have been developed in the course of Mars & Co's work with corporate clients. As such, the observations and analyses herein do not constitute a comprehensive understanding of all dynamics at play, but rather a selected and targeted list of key observations that have, for one reason or another, been important topics for our clients to understand. In addition, the accompanying information and analysis is not necessarily current, as it reflects a series of discrete work efforts conducted over the past 12-24 months.

Since we are not economists, either by training or by trade, this document should not be considered as a formal academic/political report reflecting Mars & Co's position on China's economy and its conduct. It should rather be read as an abstract of practical business pointers Mars & Co takes into account when shaping the advice its provides clients as concerns their strategies.

China's Recent Economic Growth: from 2000 to today

After years of double-digit real GDP growth from 2000 through 2007, followed by the global recession and stimulus-driven recovery from 2008-2010, China's economy has seen a steady deceleration in GDP growth since 2011.

When examining the reasons for this deceleration, we've analyzed the published statistics in two distinct ways:

1) The <u>traditional macroeconomic approach</u> looking at the contributions to GDP from consumption, investment, government spending, and net exports
2) An approach which distills GDP growth into <u>3 factors</u>: labor force growth, capital growth, and productivity growth

Each of these approaches yields key insights about the contribution to and drivers of growth in China's economy.

Using the traditional macroeconomic approach, we see three distinct periods in China's recent (past 15 years) history (*see Figure 1*):

- **Period 1 (2000-2007; 11.6% real annual GDP growth):** A build-up of investment in early years of this period (2000-2004), contributing to a rapid expansion in net exports through 2007 (even as the yuan was strengthening)
- **Period 2 (2007-2011; 9.2% real annual GDP growth)**: Net exports shrinking as a share of GDP driven by global recession and resulting slack demand in the 2007-2009 period, followed by a 2nd surge of investment, offsetting the softness in net exports
- **Period 3 (2011-today; 7.2% real annual GDP growth, and falling)**: A new, fragile "steady-state" reached with investment "stuck" at the surge levels; unlike the 2000-2007 period, the surge in investment has not translated into net export growth; growth in domestic consumption, though accelerating, has not been sufficient to make up for the weakening contribution from exports.

Using the 3-factor approach, we can begin to understand the forces driving the slowdown in the GDP and the characteristics of the different periods of growth.

In each period, we saw the increased participation in the labor force contributing an average of 0.3% per year of growth. The worst year came in 2007 when labor force participation shrank and contributed negatively to GDP by 1.4%. The best year came in 2010 as the economy rebounded from global recession and growth in labor force participation contributed 2.4% to overall GDP growth.

What is especially telling, however, is the contribution of investment and productivity to GDP in the 3 periods outlined above *(see Figure 2)*:

- **Period 1 (2000-2007; 11.6% real annual GDP growth)**: Productivity contributed an average of 5.5 ppts per year of GDP growth and investment contributed an average of 6 ppts. China's economy was experiencing the best of both worlds.
- **Period 2 (2007-2011; 9.2% real annual GDP growth)**: Productivity contributed an average of only 2 ppts per year of GDP growth and investment contributed an average of 6.6 ppts. While investment-driven growth continued and even accelerated, productivity improvements from the labor force and installed assets began to decline, suggesting a diminishing return on incremental investments.
- **Period 3 (2011-today; 7.2% real annual GDP growth, and falling)**: Productivity contributions to GDP growth have disappeared, falling to 0.2% ppts per year, and in fact turned negative by 2014. At the same time, investment continued as a contributor to GDP growth and even accelerated further, contributing 6.8 ppts per year to GDP growth.

Low-Labor-Rate Manufacturer to the World: A Strategy that's Played Out

China's rapid productivity growth of period 1 above (2000-2007) was supported by massive migration of rural migrants into cities. The mass-employment of millions of migrants in factories in the Pearl River Delta and cities like Beijing and Shanghai contributed to a surge in labor productivity and the dominance of China in multiple export-oriented manufacturing sectors requiring significant labor inputs.

Success fed on itself with entire sectors like plastics, consumer electronics and apparel building self-contained design-to-manufacture value-chains in China. This in turn contributed to further increases in productivity and double-digit GDP growth rates.

In recent years, however, migration into the cities has slowed, leading to labor shortages in manufacturing and the bidding up of manufacturing wages. Double-digit labor inflation has enabled lower cost SE Asian countries (Vietnam, Bangladesh, Philippines, ..) to become more attractive than China as Industrial bases. This has induced sharp changes in the make-up of the Chinese industrial supply chain: the outsourcing of labor-intensive parts of the supply chain to a slew of SE Asian countries as well as a drive to productivity enhancement through technology and automation.

The consequences of these major shifts have been anything but innocuous: first, the increased outsourcing has contributed to a deterioration in the Chinese current account surplus (which has even become negative in certain months) and, second, the importance of investment has been reinforced as the primary engine of growth, thus further delaying a rebalancing towards a more consumption-driven economy.

The Current Situation: An Investment Engine Increasingly Debt-Fueled

Indeed, China hasn't yet made great strides toward rebalancing to a more consumption-driven economy. With over $15T in new investment over the past 5 years, Investment not only remains the primary contributor to growth, but it has also been increasingly debt-driven.

As shown in Figure 3, total debt in China grew from ~158% of GDP in 2007 to >280% of GDP by 2014. Private debt held by households and corporations has grown to >200% of GDP in the same time frame.

By comparison to the US and Japan prior to their respective crises, the debt build-up by Chinese corporations is even more extreme *(see Figure 4)*.

Local governments have also faced an explosion in debt with over $3T believed to be owed by these entities in 2014 [1]. Given that local governments often have ownership stakes in companies, it is unclear how much of this debt is tied to corporate investments or to "vanity" infrastructure projects. Due to growing concerns on local government solvency, the central government imposed an upper limit of $2.5T on local government debt in 2015 and also created a new class of "bail-out" bonds to enable provinces to "swap out" high-interest debt [2].

The Imbalances in the Economy

In 2015, the underlying imbalances created by debt-fueled investment began to surface, though 2 events in particular appeared to catalyze a loss of confidence among consumers and investors:

- The stock market crash in June and subsequent volatility contributed to a fall in consumer confidence.
- The overnight devaluation in August signaled real concerns about the ability to maintain growth.

These events, however, were just the external manifestations of the 4 critical imbalances that are growing beneath the surface:

1) *Excess capacity in many industries*

   Through our work with clients in nearly every sector, we have seen a rapid rise in excess capacity. We have seen this dynamic in global sectors such as steel and automobiles, but also in more localized sectors. *Figure 5* shows a range of utilization rates across various industries.

   Importantly, we have seen this phenomenon accelerate since ~2011 and we even see continued announcements for capacity expansion in sectors already burdened with 30-40% excess capacity.

   The implications for our clients are twofold: 1) depending on the industry, the excess capacity tends to find a home in serving export markets – primarily the U.S. and Europe; and 2) where our clients have invested in assets to serve the local China market, price pressures are leading to "existential" questions about whether to continue to play in that market.

2) *A real estate bubble?*

   Real estate construction contributes up to a quarter of China's total GDP. Development has been outpacing sales, vacancies are on the rise, and an estimated 50M apartments were unoccupied as of 2014 [3]. The overhang has contributed to home price declines beginning in mid-2014.

3) *A banking crisis in the making?*

   With the debt-fueled overbuilding in real estate and industrial capacity, the signs of a debt crisis are looming large, with non-performing loans (NPL's) growing 35% year-on-year in the first half of 2015, after already increasing 22% year-on year in the first half of 2014 [4].

   Shadow-banking activity in China is significant, with unlisted banks accounting for ~$8T of assets (as compared to total banking assets in the U.S. of $15.5T) [5]. Thus, the official NPL figures from listed banks likely understate the extent of the problem.

4) *A depletion of the "bursting at the seams" vault*

   After peaking in the spring of 2014 at ~$4T, China's dollar reserves have been on a steady decline, with capital outflows of ~$1T in 2015, reaching a high of $158B in December 2015 [6].

   Such depletion has 4 contributing causes:

   - <u>Major changes in the industrial supply chain</u> (as mentioned above)
   - <u>Investor skittishness</u>: Economic uncertainty and the surfacing of imbalances are driving investors seeking quick returns out of the market.

- Businesses seeking globalization: Desire to expand globally coupled with relaxation of capital controls is leading to increased demand for foreign currency. This dynamic is somewhat mitigated by the ability of Chinese companies to raise funds directly on foreign exchanges.
- The major crackdown on corruption: President Xi Jinping's heavily and constantly publicized linchpin platform of ruthless crackdown has induced wealthy families to move funds offshore to avoid seizure. With the top 1% controlling 30% + of China's wealth, any flight could quickly accelerate capital outflows [7].

The Yuan Under Pressure

For many years, China was relatively immune to currency volatility with the yuan pegged to the dollar. Since this peg was underpinned by massive current account surpluses as well as investment in-flows, the strength of the peg was never really in doubt. In fact, many US participants have repeatedly complained of an artificially weak yuan which in turn potentially served to boost the competitiveness of Chinese exports.

Multiple recent events have contributed to pressures on the Dollar-Yuan peg:

1) The recent strengthening of the US dollar resulted in the yuan drifting upwards relative to other currencies. This upward currency drift combined with labor inflation in China and the economic slowdown in Europe contributed to a fall in Chinese exports.
2) In this backdrop, the Chinese government embarked on a series of cuts both in interest rates and in banks' capital reserve ratios.
3) The slowing growth rate in China combined with the relative yield attractiveness of other currencies exacerbated capital outflows from China. Capital exiting China has taken many forms - most notably the acquisition of Western companies, technology and assets by Chinese companies and the personal investments in world real estate by the affluent class in China.
4) The consequent large outflows of capital from China resulted in the yuan trading overseas at a discount to its official peg. The Chinese government, acknowledging this imbalance and, at the same time, seeking to qualify for IMF reserve currency status, shocked the markets with a surprise devaluation of the yuan in August of 2015.
5) The devaluation of the yuan appeared to have the opposite of the intended impact, as markets interpreted the move as a sign that China's problems are worse than were believed, and that China was attempting to re-stimulate growth through exports.

It is likely that a cheaper Chinese currency will, at the margin, help exports, but will not solve China's larger debt and over-investment problems. Indeed, the most recent announcement of the PBOC has to been to signal a strengthening of the yuan vs the dollar. This announcement is also unlikely to lessen the pressure on the yuan and may in fact accelerate the decline in China's forex reserves as it spends dollars to "defend" the yuan.

Future Expectations

As we contemplate the future for China's economy, we can envision three potential pathways *(see Figure 6)*:

- Scenario 1 – "Keep the Music Going": Under this scenario, the Chinese government will continue to "manufacture" growth through the continued use of debt, induced by further cuts in interest rates and banks' capital reserve ratios. While this could temporarily keep growth rates high, it will result in bigger problems down the road.

- Scenario 2 – The Restructuring Scenario: Under this scenario, the Chinese government would acknowledge the imbalances in the economy and take concerted actions to achieve mammoth restructuring both in the supply-side and the financial sectors. This scenario will inevitably lead to a sharper slow-down in the short-term, but will better position China to get back on the pathway to sustainable growth.

- Scenario 3 – "The Lost Decade": Under this scenario, the government is unsuccessful in taking on the hard restructuring actions. The massive over-capacity in multiple sectors will force heavily indebted companies into financial distress. The resulting problems with non-performing debt will cause banks to freeze lending and force the economy into a long period of sub-par growth.

The Chinese government's statements and actions give us the best picture of where the economy is headed. In September 2015, Premier Li Keqiang acknowledged that the Chinese economy had "entered a state of new normal." Further, he emphasized that the situation "has made it all the more necessary for us to press ahead with structural reform." [8] In December, the government followed up these pronouncements with a multi-point plan of action to revive the economy *(see figure 7),* including the important elements of supply side and financial restructuring necessary to reposition the economy for sustainable growth. Equally importantly, a Chinese government spokesman characterized the prospects of the economy with the statement that "The economy will follow an L-shaped path, and it won't be a V-shaped path going forward." This seems to indicate that the Chinese government is unlikely to use aggressive fiscal stimulus as the means to re-stoke growth. [9]

What is unclear at this point is the ability of the government to successfully deliver on the stated plan. The historical track record on supply-side restructuring is spotty, and restructuring the financial sector is a new problem for the government to solve.

While the necessary policy actions have yet to bear fruit, there remain multiple reasons to be hopeful for China:

1) The Chinese consumer: While the manufacturing & real estate economy continue to falter, the Chinese consumer appears resilient; China's "millennial" consumer, having experienced one of the greatest booms in history, continues to behave aspirationally.
2) Tier 3 & 4 cities: We see a maturing of the economies in tier 1&2 cities, with growth in bellwether sectors such as automotive resembling that of the U.S. and Europe; Tier 3 and 4

cities, however, are at much earlier stages of development and are continuing to see healthy growth.

3) Availability of policy levers: The Chinese government has some untapped policy levers available to it; for example, bank reserve requirements in China are still close to 2X the reserve requirements in the U.S.
4) Limited Dollar Debt – While China's overall debt burden is high at $28T, only ~$1T of this is denominated in foreign exchange.
5) Declining Oil Prices – As a large net importer of oil, China is a big beneficiary of declining oil prices.

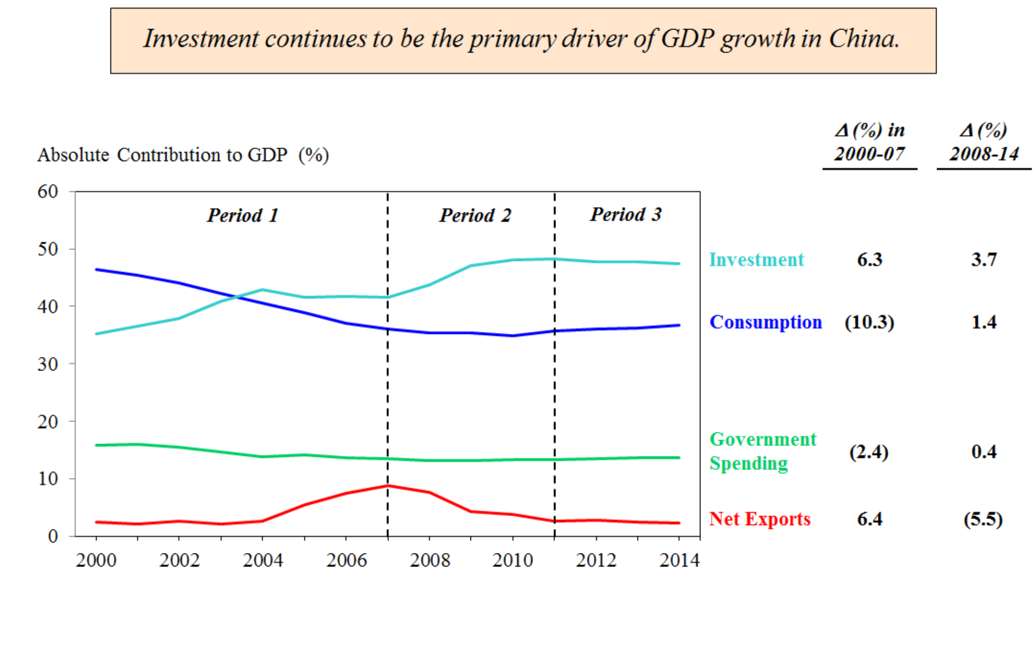
China's economy faces serious systemic threats in the short term, and structural reforms are necessary. If such actions are undertaken, the intrinsic strengths outlined above will enable a "re-basing" of the economy and a return to sustainable growth, saving it from a "Japan-like" lost decade.

A Few Pointers for the Western Businessperson

- China remains a debt-fueled investment-driven economy
- Excess capacity is becoming a fact of life in an increasingly large number of sectors
- Remain "on your toes" about possible mammoth restructurings of state-owned entities in sectors you're participating in
- Pay specific attention to the choice of possible partners and to the details of partnership agreements
- Major destabilizing "events" (real estate bubble popping, emerging banking system crisis, capital control tightening, competitive devaluations and contagion, etc.) carry various degrees of probability of happening, but must be incorporated into forward thinking plans
- The Chinese government keeps honing its plans and it's important to stay abreast of them; as with the Fed, "one can't afford to bet against the Party"

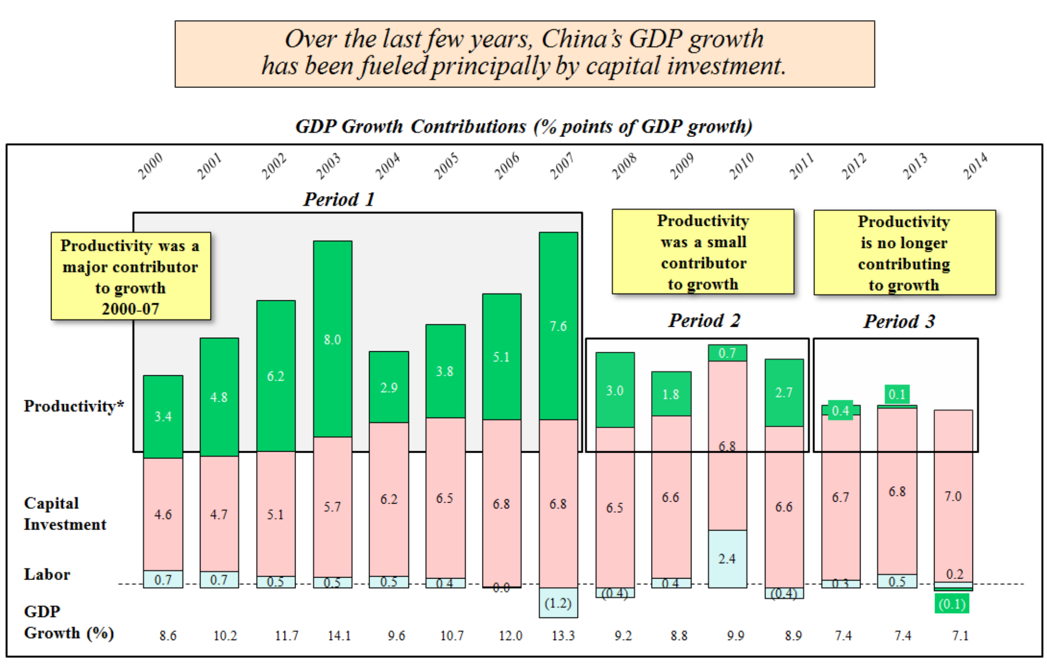
Appendix

FIGURE 1: PERCENTAGE OF GDP BY COMPONENT
CHINA



Sources: Euromonitor; Mars & Co Analysis

FIGURE 2: PRODUCTIVITY CONTRIBUTION TO CHINA'S GDP GROWTH

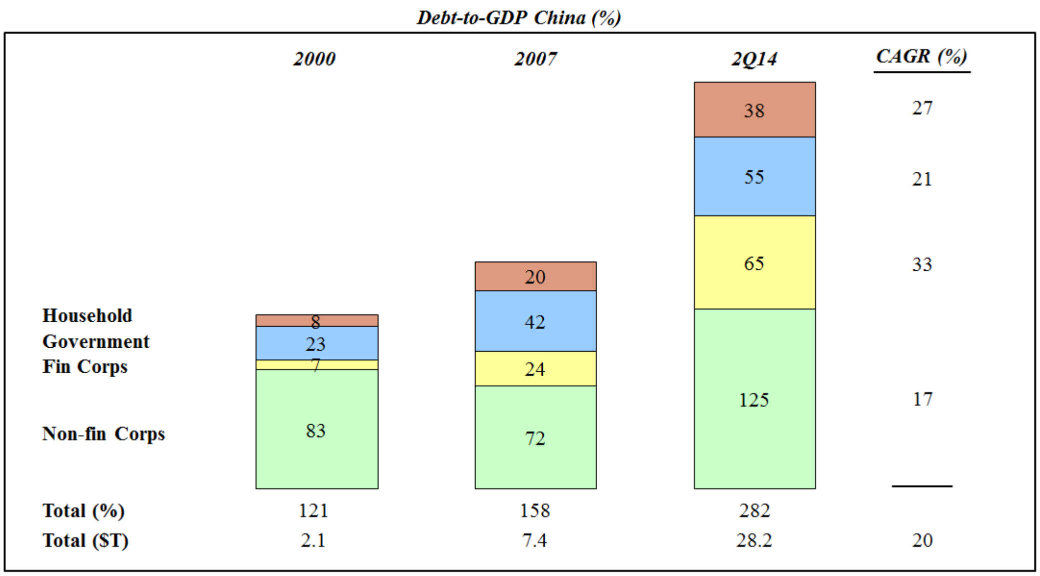


* Total factor productivity independent of capital inputs
** Real GDP (based on 2000 prices)

Sources: Conference Board; Euromonitor; Mars & Co Analysis

FIGURE 3: DEBT CRISIS

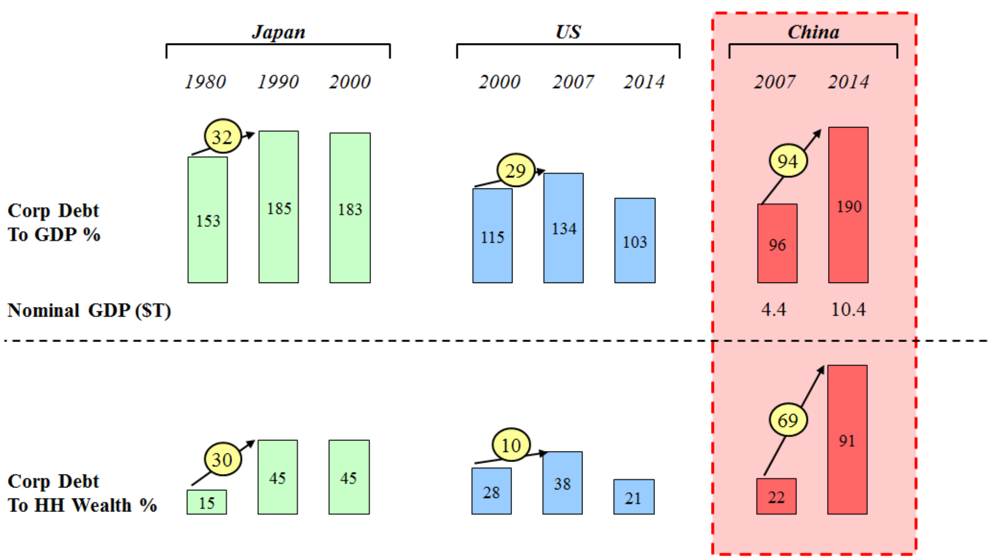
Overall debt levels in China have grown 10-fold over the last 15 years, with corporate debt contributing to the bulk of the increase.



Sources: MGI Country Debt database; World Bank; S&P; Credit Suisse; The Atlantic; Mars & Co Analysis

FIGURE 4: CORPORATE DEBT BUILD UP

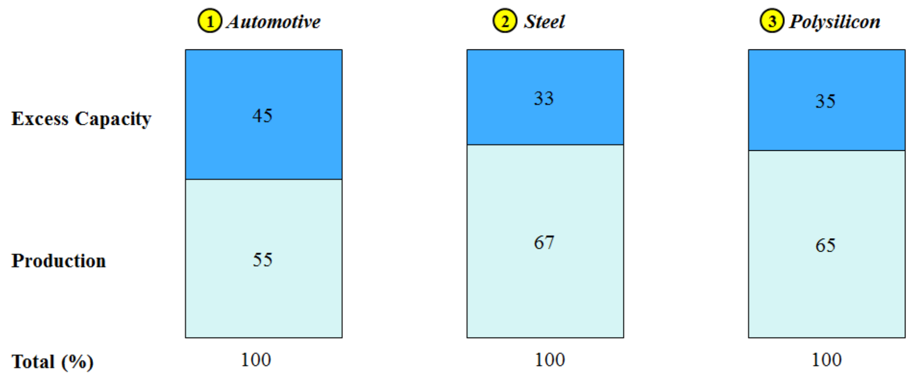
Corporate debt build-up in China has been even more aggressive than Japan and the US prior to their respective financial crises.



Sources: World Bank; Credit Suisse; MGI; Mars & Co Analysis

FIGURE 5: EXCESS CAPACITY IN MULTIPLE INDUSTRIES
2014 / 15

Multiple industries where China has significant excess capacity.



1 *Largest auto market in the world, but* ***excess capacity of ~20 M vehicles***
2 *33% excess capacity in steel plus* ***anti-dumping complaints*** *world over*
3 *35%* ***excess polysilicon capacity even after government restructuring*** *announcements*

Sources: CAAM; IHS; World Steel; OECD; MIIT; IEA; Mars & Co Analysis

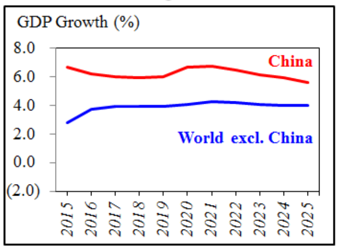
mars & co

FIGURE 6: CHINA MACRO GDP GROWTH SCENARIOS

There are three scenarios to consider for China's macro growth trajectory, which will impact global growth rates.

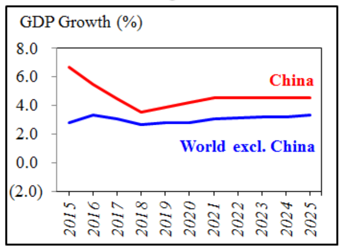
Keep the Music Going ("Base")

- Try to keep macro-economic growth going without causing pain
- **"Manufacture" growth through government investment**
  - Sustaining **high growth with new govt debt** (another ~$15T !!)
  - A bigger problem down the road but 6-7% continues for now



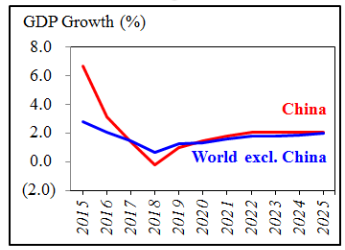
China Restructuring Scenario

- **Supply-side restructuring** with urgency:
  - **Rationalize excess capacity** and **consolidate industries**
- **Bank restructuring & recapitalization**:
  - Write off non-viable debt
  - Recapitalize banks (govt capital)
- **Short-term pain,** but long-term **viable macro-growth model of 3-4%**



"Lost Decade" Scenario

- **Refusal to fully acknowledge** the building imbalances
- **Consumer confidence loss** combined with **financial distress at companies**
- **Balance-sheet distress at banks** clogs up lending
- Macro-growth continues to fall ➔ **China "loses" a decade or more**



Sources: World Bank; IMF; Mars & Co Analysis

FIGURE 7: ANNOUNCED ECONOMIC REFORMS IN CHINA
SUMMARY

In December 2015, Chinese leaders approved an economic plan that calls for several reforms intended to improve a slowing economy.

Announced Reform	*Summary*
Rationalize industrial oversupply	• **Rationalize manufacturing capacity**, particularly in industries like steel and glass • Support **M&A activity** rather than bankruptcy when possible
Reduce property inventories	• Use **"Hukou" reform** as means **to enable migrant workers to buy property** • Encourage **consolidation amongst real estate developers**
Deleverage local governments	• Reduce debt burden on local governments through **government debt swaps** • Increase **oversight and risk monitoring** across the financial system
Lower corporate costs	• **Reduce taxes** and social security contribution rates + **streamline administrative procedures** • Lower financing costs and create a more stable interest rate environment
Improve technological efficiency and innovation	• Provide support to enterprises to **invest in hardware / software infrastructure** • Cultivate the development of **new industries and accelerate commercial innovation**
"More forceful" fiscal policy	• Gradually **raise fiscal deficit** ratio • Reduce tax rates + increase spending on welfare and job training
"More flexible" monetary policy	• **Likely continued easing** • Replace benchmark deposit and lending rates with an **interest-rate corridor**

Sources: Lit search; Mars & Co Analysis

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6) "China Capital Outflows Rise to Estimated $1 Trillion in 2015", *Bloomberg*, January 25, 2016
7) "China's 1 Percent vs. America's 1 Percent", *Bloomberg Business*, July 28, 2014
8) "Chinese Premier Li Keqiang's speech at Davos 2015", World Economic Forum, http://www.weforum.org/
9) "Chinese leaders approve economic plan for 2016", Wall Street Journal, Dec 22, 2015

OPENING STATEMENT OF DR. JASON M. THOMAS
MANAGING DIRECTOR AND DIRECTOR OF RESEARCH, CARLYLE GROUP

DR. THOMAS: Thank you very much.

My primary responsibility at Carlyle is analysis of our portfolio to try to get a sense of growth rates that were observed and compare them to official statistics and advise our investment committees.

So right now with regard to China, I'd say that our biggest concern is industrial overcapacity, and we think when trying to analyze the future, what we anticipate, there's three things that we are hoping to see to address these problems:

The first is monetary easing to reduce real interest rates and real debt service burdens in China.

The second is structural reform to eliminate excess capacity. That's both through liquidations, which are obviously politically sensitive, but then also through business combinations that reduce capacity. There's also the ability to reduce capacity via environmental regulations so as to take out of service those factories that don't meet heightened requirements.

And then third is financial sector reform to address nonperforming loans, both those nonperforming loans that currently exist, and also those nonperforming loans that are likely to be created as a result of the industrial consolidation.

So when we think about China and the spillovers to the U.S. economy and global economy, the slowdown in China's GDP growth has been really concentrated in manufacturing and fixed investment activities so infrastructure, property development, business capex, and the spillovers in the U.S. have been primarily felt in our industrial sector.

There's direct effects, and China is 25 percent of global manufacturing output. It's very well integrated into global supply chain so any slowdown in China is going to directly reduce orders for intermediate and capital goods in the United States and elsewhere. There's also this indirect effect as China, as this industrial sector, slows down, the demand for industrial inputs slows.

So then you have price declines in iron ore, rubber, of course oil, and then that has an impact by, you know, there's very few projects that are net present value positive with an oil price of $30. So spending on development projects has collapsed, and that's probably the biggest contributor to the contraction in U.S. industrial production over the course of 2015. This is not entirely China's fault, but I think that there's a very large share of the decline in demand from China that's attributable to China, and China, of course, became the marginal buyer of all these commodities. If you look at Chinese consumption of many industrial commodities, they accounted for almost 100 percent of the net growth between 2005 and 2012 so, you know, played an outsized role in these markets.

So I would say that the investment boom that occurred that Mr. Turner mentioned following the global financial crisis, China had a choice of either really accepting a deceleration in growth rates when external demand collapsed or essentially filling that hole, so to speak, filling that hole through fixed investment.

And when you look in the decline in the current account, for example, from ten percent of GDP to a surplus of two percent of GDP, that lost national income is essentially replaced by a boom in fixed investment that went from 41 to 49 percent. So it's very interesting, but the numbers here almost exactly fit to one another.

And this would have been I think a pretty reasonable strategy had there been a Vshape recovery in global demand following the crisis especially in the United States. Of course, as we know, demand remains sluggish. We've had a sluggish recovery. So instead of having a very short-lived investment boom and stimulus to essentially tide the economy over while global demand recovered, the fixed investment spending continued for some time.

And a lot of people are very focused on indebtedness, and certainly it's a concern we share, but I think there's a simpler way to look at it, which is just a decline in the return on fixed investment. The marginal product of capital in China has come down quite significantly. In fact, it looks like it's halved since 2007, and right now the returns on gross fixed capital formation in China are very similar to those in advanced economies. And that's unusual because China's living standards are still very low. It's still at a very early stage of its development to have such low returns on capital. So that's a strong indicator that there's a significant overcapacity.

In the last few minutes, I just want to talk about the reforms that I anticipate. First, the overcapacity has led to significant deflation in producer prices, and that's not just the cost of inputs. It's the cost of finished manufactured goods. Finished manufactured goods are falling--the prices of finished manufacturing goods are falling at about 5.5 percent annualized rate.

When you look at the outstanding stock of debt in China, the effective interest rate is something like 6.5 percent. So if you add those two together, you have real interest rates of about 12 percent. That's much too high to be serviced in today's decelerating real growth rates so you have a real potential problem, you know, crisis because of the real debt service cost being so high.

The ultimate scale of the problem here is going to be a function of the real interest rate, and so I think more monetary accommodation is certainly necessary to try to bring real interest rates down, but it's difficult to achieve the monetary accommodation absent further move in the exchange rate, further downward move on the exchange rate.

The reason for that is the purchasing price index in China is very sensitive to the exchange rate. There's a pass through of about .4 of a percent, which is to say that a ten percent increase in the exchange rate reduces purchasing price index in China by about four percent, and as the RMB has ridden up with the dollar against the currencies of trading partners, that's been a main source of deflation.

As market participants in China, businesses and households, have been increasingly concerned about the need for further depreciation, they've tried to repay debts, and they've tried to get money out of China as quickly as possible.

Also, when you think about the legacy of capital controls in China, there's significant latent demand to diversify outside of China. At the end of 2014, Chinese residents held only $262 billion in foreign stocks and bonds, equal to 2.5 percent of China's GDP. In the United States, the comparable number is 55 percent of GDP. So when you look at analyses from the IMF and other observers, if they were completely unencumbered, if there were no capital controls to speak of, there could be $1.5 trillion that flees China overnight, again, simply seeking to diversify their portfolios, hold non-RMB denominated securities.

So that's the issue that we're facing right now, a desire to address the deflation, the inability to address deflation without further movement on the exchange rate, the anticipation of further movement on the exchange rate leading to or intensifying the fund outflows, and then that, of course, is leading to declines in foreign exchange reserves, which are falling at a pretty significant clip.

So just, again, to summarize, I think that there needs to be further monetary easing to reduce real interest rates in China, real debt service burdens.

Number two, I think the structural reform so as to reduce capacity through liquidations, business combinations, and then, of course, environmental reform.

And then the third issue, again, is that the foreign exchange reserves are finite. They seemed so massive and nearly infinite for a long period of time, but when you start to lose them at $100 billion per month clip, you recognize how finite they are, and those foreign exchange reserves could be better served recapitalizing the banking system, you know, both dealing with nonperforming loans now, but again nonperforming loans that are going to be created as opposed to, in my opinion, defending a currency that is likely to be overvalued, at least in the short term, given the amount of money that is seeking to exit China at the moment.

So thank you very much, and of course there's a lot more information in my testimony that I'd be happy to discuss.

PREPARED STATEMENT OF DR. JASON M. THOMAS MANAGING DIRECTOR AND DIRECTOR OF RESEARCH, CARLYLE GROUP

February 24, 2016

Jason M. Thomas
The Carlyle Group
Testimony before the U.S.-China Economic and Security Review Commission:
Recent Trends in China's Economy

Summary

The main economic challenge China faces today is industrial overcapacity, a situation that stems, in part, from excessive capital accumulation in the wake of the Global Financial Crisis (GFC). A strategy to address overcapacity is likely involve three key elements: (1) monetary easing to reduce real interest rates and debt service burdens; (2) structural reform to eliminate excess capacity through business combinations and liquidations; and (3) financial sector reform to address existing nonperforming loans and those created by industrial consolidation.

The U.S. has a significant national interest in China's continued growth. At the end of 2015, China accounted for over 17% of global GDP (on a purchasing power parity basis) and over one- third of the growth in global demand.[1] The *growth* in Chinese household spending in 2015 exceeded $380 billion – roughly the size of the entire Austrian economy. As China has integrated into the global economy, it has become the key economic platform for the final processing of manufactured goods and the main driver of demand for primary inputs (steel, etc.), intermediate goods (machined parts and precision tools), and capital goods (tractors and turbines) produced by U.S. manufacturers. In short, a significant further deceleration in Chinese growth, or outright contraction, would be very damaging for the U.S. and global economies.

The slowdown in annual Chinese GDP growth from 10% prior to the GFC to 6.8% in 2015 has been concentrated in manufacturing and fixed investment (infrastructure, property development, and business capex). As a result, the spillovers in the U.S. to-date have been felt in the industrial and resources sectors. China accounts for nearly 25% of global manufacturing output.[2] Any slowdown has a *direct* impact on global industrial orders given the economy's importance to global supply chains. At the same time, slowing manufacturing and investment growth in China also depresses industrial orders *indirectly* through weaker-than-expected demand for industrial inputs (iron ore, copper, oil distillates, etc.). Most of the observed weakness in the global industrial sector is attributable to the collapse in development spending in the energy, metals, and mining sector, as low commodity prices make new development projects uneconomic.

The decline in commodity prices also has raised difficult questions about potential losses on the large stock of credit issued to fund past resource development in the U.S. and elsewhere. Since November 2014, the market value of speculative grade bonds issued by firms in the energy, metals, and mining sectors has fallen by over 40%, on average. As the stock of commodity-linked speculative grade debt exceeds $500 billion, fair value losses of this magnitude have led to retrenchment among creditors and have contributed to a 2 percentage point average increase in speculative grade borrowing costs in the broader U.S. economy.[3]

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[1] IMF, World Economic Outlook Database, October 2015.
[2] Focus: Global Supply Chain and Logistics, March 2015.
[3] Federal Reserve, Shared National Credits, October 2015. Bank of America Merrill Lynch Global Index System Database.

As services and consumption account for a larger share of Chinese GDP, a given amount of growth will generate less incremental demand for industrial inputs. As a result, it seems unlikely that demand in China will rebound to the growth trajectory necessary to reverse current fixed investment trends. Commodity prices are likely to rebound, but only after depletion of existing resources causes supply to adjust downward.

The key issue for the U.S. today is that China pursues the structural and countercyclical policies necessary to prevent conditions from deteriorating further and placing global growth at risk. It will likely prove difficult for China to contain current risks to growth without more accommodative monetary policy, which will likely include further currency depreciation. Although not a first-best solution from the U.S. perspective, the benefits of a stronger Chinese economy are likely to far outweigh any competitive advantage derived from a strong renminbi (RMB).

A weaker currency increases inflation pass-through from imports and raises inflation expectations, both of which help to ease financial conditions. Since June 2011, the RMB has appreciated by 24% on a trade-weighted basis, with over half of the appreciation occurring since June 2014. Easing is not designed to siphon demand from trading partners, but to reverse the tightening of domestic financial conditions stemming from currency appreciation. Although China continues to run a large current account surplus and the RMB would be expected to appreciate over the medium-to-long term, current trends in prices and capital outflows suggest that the RMB would likely weaken materially against the U.S. dollar in the absence of official intervention.

Chinese Industrial Overcapacity

Between 2008 and 2011, real fixed investment grew at a 14% annual rate and peaked at nearly 50% of China's GDP. This countercyclical spending allowed China to meet GDP growth targets at a time when external demand collapsed. Between 2007 and 2013, the share of Chinese output consumed by the rest of the world declined by 12 percentage points (from 35% to 23%), as China's growth model shifted from exports to domestic investment.

The legacy of this investment boom is evident today in declining sales and profitability ratios. Since the end of 2011, asset turnover among public companies has declined by 20% (Figure 1); operating margins at the same group of businesses have contracted by 15%, on average; and Chinese producer prices have contracted on an annual basis for 48 consecutive months and are currently falling at a 6% annual rate. Included in this survey are finished manufactured goods, whose prices are declining by a 5.4% annual rate.

In addition, China's aggregate return on incremental capital – the amount of real GDP generated per unit of incremental gross fixed capital formation – has roughly halved since the financial crisis, falling from 27.5% in 2007 to 14% last year as the productivity of recent investment has fallen relative to prior trends (Figure 2). As the capital stock expands, returns naturally decline. The gains derived from the first wave of infrastructure spending on roads, ports, and rail far exceed those from second and third generation projects. But given China's relatively low per capita income level, the scale of the decline suggests that some portion of the recent fixed investment has been duplicative or otherwise inefficient.

Global Spillovers

Chinese growth has been concentrated in areas like manufacturing, property development, and infrastructure that require significant amounts of energy, steel, industrial commodities, and (largely U.S., German, and Japanese) high value-added capital equipment. Over the past decade, China became the marginal purchaser of many industrial commodities, accounting for virtually all of the observed growth in global demand for iron ore, aluminum, copper, nickel, and many distillates.[4] Increased Chinese demand for industrial inputs contributed to significant growth in global capital spending (capex) on resource development projects in the metals, mining, and energy sectors.

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[4] World Bureau of Metal Statistics. Roche, S. (2012), "China's Impact on World Commodity Markets," IMF Working Paper.

Since 1996, the annual GDP growth rate in emerging market economies (EME) has been nearly 90% correlated with annual changes in commodity prices (Figure 3). Increases in commodity prices boosted exports and incomes in commodity-exporting EMEs like Brazil, Colombia, Russia, and South Africa and also stimulated new fixed investment in mining, metals, and energy exploration and production. The surge in EM fixed investment between 2003 and 2012 created significant demand for excavators, trucks, metal cutting tools, vacuums, compressors, transmissions, and other capital equipment largely produced in advanced economies like the U.S. The North American shale boom between 2009 and 2013 further augmented the sales of mining and energy-related industrial equipment manufacturers.

As Chinese demand has slowed (Figure 4), the global capex cycle has reversed. Chinese fixed investment growth slowed to a 2% annual rate in 2015;[5] growth in industrial production also slowed considerably from its 2009-2012 average and is now contracting in nominal terms (Figure 5). As commodity prices cratered, incomes and investment in EM economies dropped sharply. GDP growth in EMEs since 2012 has fallen 3 percentage points below its 2003-2011 average and continues to decelerate as commodity prices soften further.

Carlyle portfolio data calibrated to the Fed industrial production index suggest that orders for capital equipment used oil and gas production contracted by 35% in 2015 and continue to fall at a 20% annual rate in January 2016. Orders for inputs used to manufacture industrial drills declined by over 40% in 2015 and are falling at a 50% annual rate globally. Equipment rentals at copper, metallurgical coal, and iron ore mines have dropped at an average annual rate of 30% in 2015.[6] Analysts now expect that equipment purchases by energy businesses will contract by an additional 50% from 2015 levels,[7] while mining firms will cut capex by an additional 36% over the next two years.[8] Globally, capex is expected to fall by 4% in 2016 as the decline in spending among energy and commodities businesses offsets the modest increase expected in other sectors.[9]

None of this suggests that China is the sole cause of the commodity price declines and corresponding drops in industrial activity. The increase in the foreign exchange value of the U.S. dollar – the currency in which commodities are invoiced – has also played a major role in the price declines, as have dramatic increases in productivity of recent resource investments.

Tightening Financial Conditions

In recent quarters, the sharp fall in Chinese producer prices (-6% annual rate) has spilled over to the broader economy, with China's GDP deflator declining at an annual rate of between 0.7% and 1.5%. Deflation is of such great concern to policymakers because persistent declines in prices tighten financial conditions by increasing real interest rates and debt service burdens. Tighter financial conditions reduce incentives to spend or invest and increase funding pressures and default risks.

A tightening of financial conditions is of particular concern in China given high levels of debt concentrated in industries most impacted by deflation. As of June 2015, nonfinancial corporate debt was equal to 163% of GDP, but 83% of that debt was owed by firms in the mining, construction, and manufacturing industries.[10] With a weighted average lending rate of 6.25% in 2015, real interest rates in the industrial sector are in excess of 12% - much too high relative to decelerating real growth rates.[11]

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[5] This calculation is based on the fixed investment share of real GDP as measured by the IMF.
[6] Carlyle Analysis of portfolio company data.
[7] IHS Energy Analysis of North American Energy E&P Companies, February 2016.
[8] Bloomberg Intelligence, Mining Sector, August 15, 2015.
[9] S&P, 2015 Global Capex Survey, August 3, 2015.
[10] Chivakul, M. and Lam, W.R. (2015), "Assessing China's Corporate Sector Vulnerabilities," IMF Working Paper 15/72.
[11] China Monetary Policy Report, Quarters One and Two, 2015.

For the nonfinancial corporate sector as a whole, debt service ratios – interest payments plus amortizations to income – have risen by 6 percentage points since the end of 2007.[12] However, when accounting for the decline in trend inflation, debt service burdens have more than doubled, from 8% of nonfinancial corporate income in 2007 to more than 20% in 2015 (Figure 6). When trend inflation averaged 6% between 2004 and 2008, corporate receipts were growing at a 16% nominal rate – fast enough to easily service increased debt burdens. The sharp decline in nominal income growth means an inordinate share of current income must be devoted to servicing past indebtedness.

Monetary Policy Response

If an advanced economy, like the U.S., euro area, Japan, or United Kingdom were faced with a similar circumstance of debt overhang, slowing growth, and tightening financial conditions, monetary authorities would respond forcefully through rate reductions and balance sheet policies like quantitative easing (QE) to reduce real interest rates and provide incentives to boost spending. Chinese policymakers have not yet pursued similar policies because their freedom of action is circumscribed by the RMB's *de facto* peg to the U.S. dollar.[13]

Exchange rates depend on parity conditions governed by differentials in expected returns across economies. When a central bank reduces domestic interest rates, the "equilibrium" exchange rate declines to compensate. For example, when the Federal Reserve responded to the fallout from the Great Recession by reducing the fed funds rate to 10 basis points and launching QE, the U.S. dollar fell by 16% on a trade-weighted basis. Domestic investors sold U.S. dollar-denominated bonds to buy higher-yielding foreign assets. This net selling continued until the dollar reached a level where its expected long-run appreciation compensated for the drop in interest income.

In an economy that "pegs" its currency to that of a trading partner, the necessary adjustment in the exchange rate cannot occur and capital continues to flow out of the economy. Maintaining a pegged exchange rate, or tightly managed float, forces the PBOC to choose between the (higher) interest rates required to maintain parity against the U.S. dollar and the (lower) interest rates necessary to ease financial conditions and stimulate domestic demand.[14] Without currency liberalization, monetary easing would likely accelerate the pace of capital outflows and make further financial liberalization impossible in the near term.

To increase freedom over domestic monetary policy, Chinese authorities may gradually relinquish control over the currency. In its annual review of the Chinese economy, the IMF suggested recent currency reforms were an important step towards an "effectively floating exchange rate regime within 2–3 years."[15] Such a transition will likely require further moderate depreciation this year as the market-based RMB quotation system launched in August 2015 is allowed to operate more freely.

Rather than a provocation that seeks to "steal" sales from other economies, currency liberalization should be interpreted as part of a domestic reflation strategy. Chinese authorities are likely to follow RMB devaluation with monetary stimulus through reductions in benchmark lending rates, increases in liquidity injections to the interbank market, and more targeted reductions in some banks' required reserve ratios (RRR). There is ample scope for policy easing: one-year lending rates to nonfinancial borrowers stand at 4.35%, the one-year SHIBOR interbank rate is 3.25%, and the one-year "offshore" interbank rate exceeds 5%.[16]

"True" Market Value of the RMB Likely Below Current Levels

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[12] BIS debt service ratios statistics, November 2015.
[13] For constraints on monetary autonomy introduced by fixed currency regime see: Krugman, P. (2000), *Currency Crises,* National Bureau of Economic Research.
[14] Glick, R. and Hutchinson, M. (2009), "Navigating the trilemma: Capital flows and monetary policy in China," *Journal of Asian Economics*.
[15] "China's Transition to Slower But Better Growth," IMF Survey, August 14, 2015.
[16] Bloomberg, Accessed February 17, 2016.

Relinquishing control over the currency should also boost domestic inflation rates through exchange-rate pass-through. Empirical studies find that every 1% appreciation in China's real effective exchange rate reduces PPI inflation rate by 0.495%.[17] This relatively high degree of PPI pass-through suggests that deflation in the industrial sector may be largely attributable to the RMB's sharp rise relative to the currencies of China's trading partners over the past few years. Movements in the exchange rate are far more important for hitting inflation targets than boosting net exports.[18] The exports of economies integrated into global value chains like China's tend to have high import content, which neutralizes the real benefits of depreciation.[19]

Between 2004 and 2011, the RMB appreciated by 56% against the U.S. dollar, in real terms, thanks to a 30% nominal appreciation from the "crawling peg" instituted in 2005 and a 25% increase in relative production costs.[20] The RMB's appreciation against the dollar was generally consistent with that of other major currencies over that period. Since 2011, however, most Asia-Pacific and emerging market currencies began to fall, in real terms, against the U.S. dollar while the RMB continued to strengthen (Figure 7). Relative to a trade-weighted basket that includes currencies of key trading partners like the U.S. dollar, Japanese yen, Korean won, Australian dollar, and euro, the RMB has appreciated by 26% between June 2011 and January 2016 (Figure 8).[21] Deflation may be a sign of an "internal devaluation" where domestic prices fall relative to external prices to compensate for an overvalued real exchange rate.

Signs of an overvalued exchange rate are also evident in balance of payments data. Since June 2014, China's foreign exchange reserves have declined by nearly $800 billion despite a current account surplus in excess of $200 billion over that time.[22] The decline is partly due to valuation losses on non-dollar portfolio holdings, but mostly reflects the desire of Chinese households and businesses to sell RMB to repay existing dollar debts and diversify into other currencies. While such diversification is generally proscribed by capital controls – which have been strengthened in recent months – foreign trade provides significant loopholes for residents to send capital abroad. Eventual liberalization of the capital account and RMB internationalization will make the exchange rate more sensitive to portfolio allocation decisions.

Chinese households are significantly under-diversified globally, which makes financial flows especially sensitive to changes in interest rates and expected exchange rates. At the end of 2014, Chinese residents' foreign portfolio assets equaled just $262 billion, or 2.5% of GDP.[23] By comparison, foreign assets in U.S. residents' portfolios were equal to $9.56 trillion, or 55% of U.S. GDP.[24] While these ratios are not directly comparable because the wealth/GDP of the U.S. is much greater, they suggest that China's capital controls have created strong latent demand for foreign assets. This latent demand helps to explain why the exchange rate could be overvalued at this point in China's business cycle even in the presence of large current account and trade surpluses.

Data from the IMF and Bank for International Settlements (BIS) suggest that a large share of the outflows thus far is attributable to repayment of U.S. dollar-denominated debt by Chinese businesses. As of mid-2015, Chinese residents owed about $1.1 trillion of U.S. dollar denominated debt, equal to about 5% of total domestic credit.[25] The relatively low share of U.S. dollar funding suggests that a decline in the RMB will have a limited impact on Chinese corporations, with the notable exception of the property sector, which borrows heavily in dollars but has no source of dollar earnings.[26]

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[17] Jin, X. (2012), "An Empirical Study of Exchange Rate Pass-Through in China," *Panoeconomicus,* March 2012.
[18] Woodford, M. (2007), "Globalization and Monetary Control," NBER Working Paper No. 13329.
[19] Abmed, S. et al. (2015), "Depreciations without Exports," World Bank Policy Research Working Paper
[20] IMF, 2015 WEO Database. The GDP deflator is an imperfect proxy for factor costs, see: Bayoumi, T, et al. (2013), "Measuring Competitiveness: Trade in Goods or Tasks," IMF Working Paper.
[21] Obtained via Bloomberg, February 2, 2016.
[22] People's Bank of China, Foreign Exchange Reserves, July 31, 2015.
[23] People's Bank of China, December 31, 2014.
[24] U.S. Bureau of Economic Analysis, December 31, 2014.
[25] McCauley, R. (2015), "Global Dollar Credit," Bank for International Settlements.
[26] Chivakul, M. and Lam, W.R. (2015), "Assessing China's Corporate Sector Vulnerabilities," IMF Working Paper 15/72

Conclusion

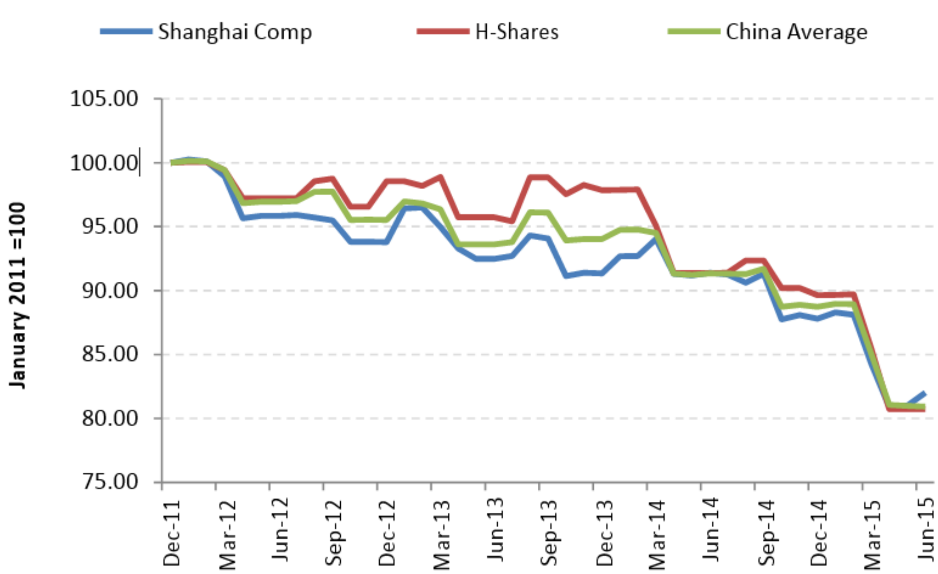
China is in the midst of a multi-year slowdown concentrated in the industrial and fixed investment sectors that has been exacerbated by sharp real exchange rate appreciation since June 2014. The key issue today for the U.S. is that China pursues the structural and countercyclical policies necessary to prevent conditions from deteriorating further and placing global growth at risk. A recession in China – which accounts for one-third of global demand growth – would be especially damaging to the U.S. and global economies.

A policy strategy to address these issues is likely to involve three key elements: (1) monetary easing to reduce real interest rates and debt service burdens; (2) structural reform to eliminate excess capacity through business combinations and bankruptcies; and (3) financial sector reform to address existing nonperforming loans and those created by industrial consolidation.

The first pillar – monetary easing – requires more currency flexibility to allow the exchange rate to adjust naturally to reductions in domestic interest rates. The foreign exchange value of the RMB is currently above levels that would likely prevail in the absence of foreign intervention. The sharp rise of the RMB relative to the currencies of trading partners also helps to explain the scale of the domestic deflation currently plaguing the Chinese economy. Rather than a provocation, a decline in the RMB from further market liberalization should be viewed as part of a broader reflation strategy aimed at averting a far-worse outcome for the global economy.

Appendix

Figure 1: Sales/Book Value of Assets (Scaled to 2011)[27]



[27] Carlyle Analysis; S&P Capital IQ Database.

Figure 2: Aggregate Return on Incremental Capital in China[28]

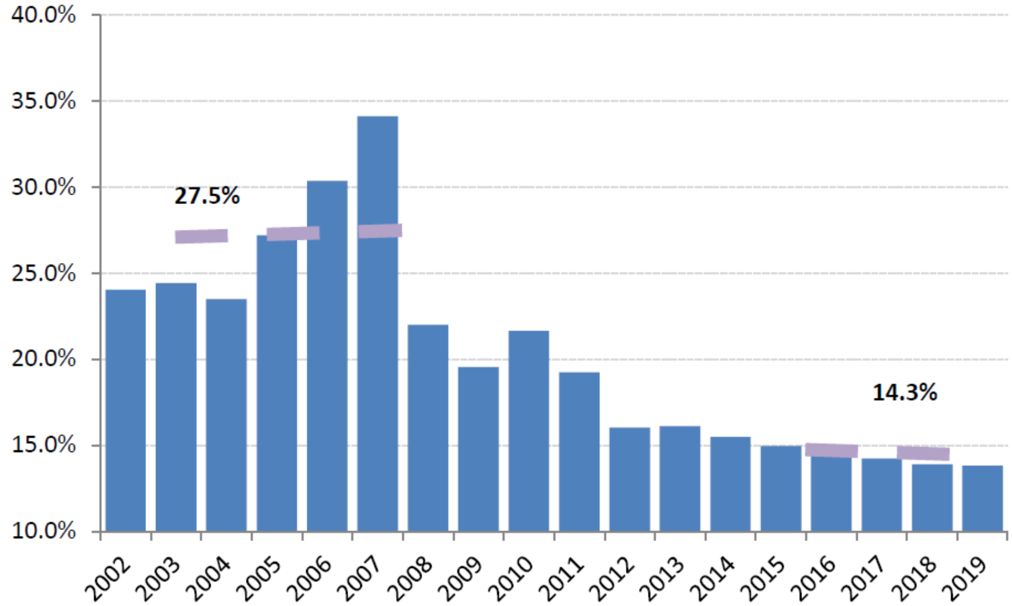
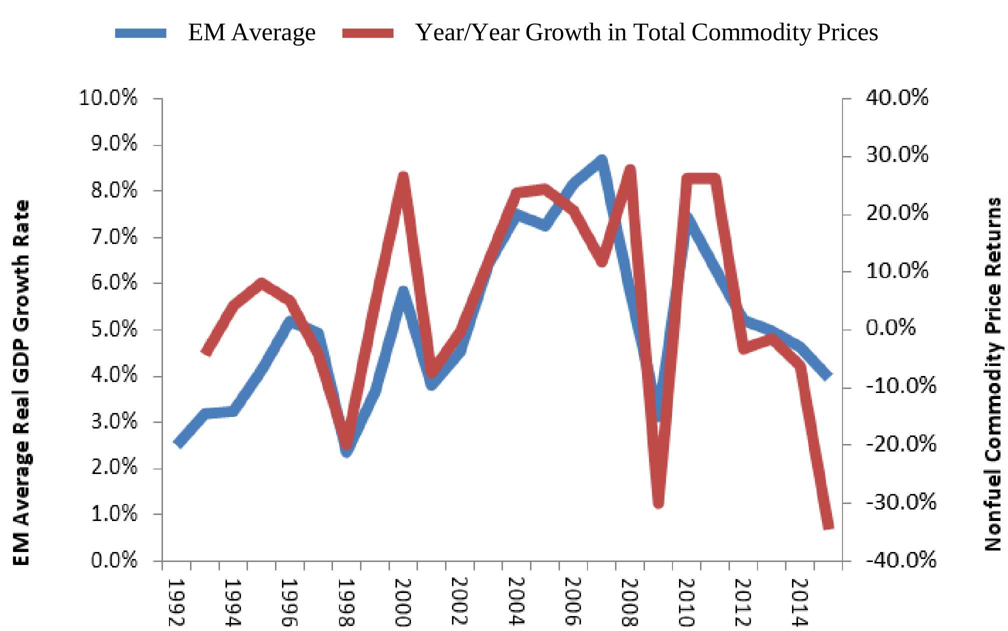


Figure 3: Correlation Between EM GDP Growth and Commodity Price Changes[29]



[28] Carlyle Analysis; IMF World Economic Outlook Database, October 2015.
[29] Carlyle Analysis; IMF World Economic Outlook Database, October 2015.

Figure 4: Chinese Demand for Commodities: Carlyle Asia-Pacific Seaborne Commodity

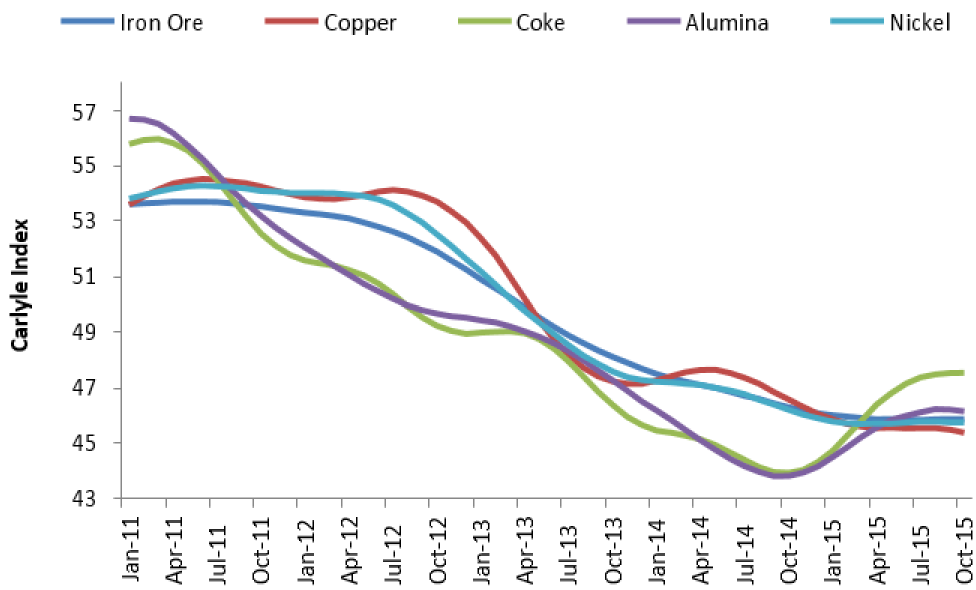
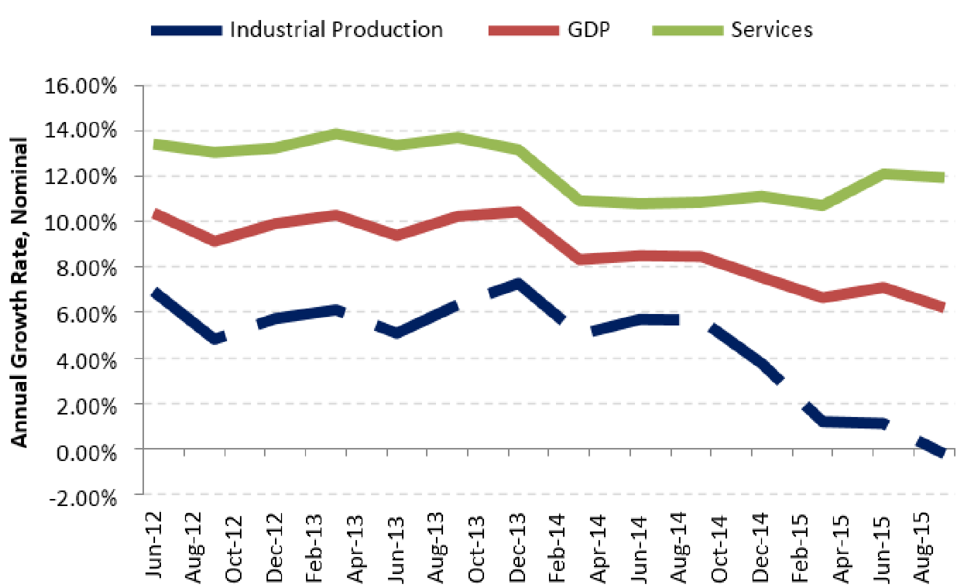


Figure 5: Nominal GDP Growth Rates[30]



[30] China National Bureau of Statistics.

Figure 6: Nonfinancial Debt Service Ratios in China[31]

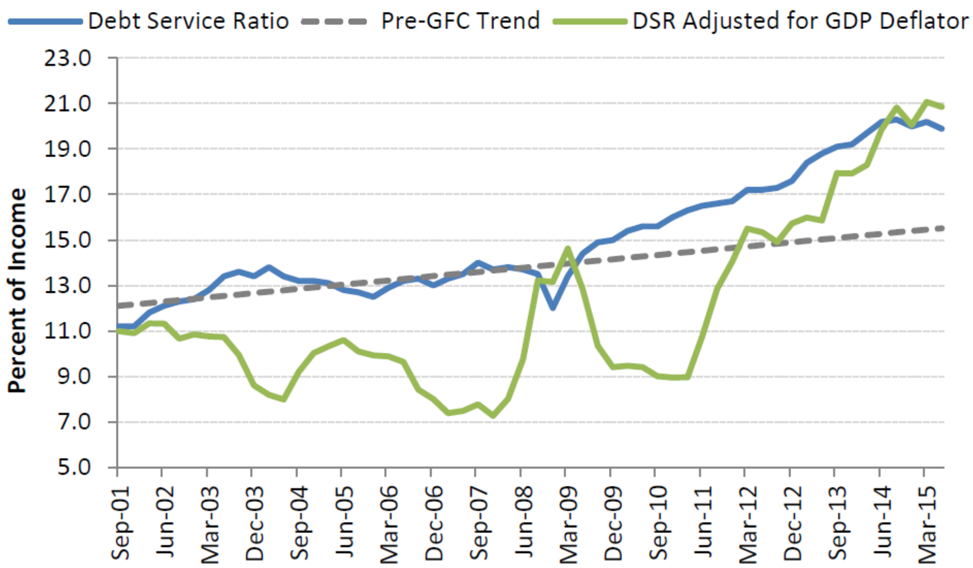
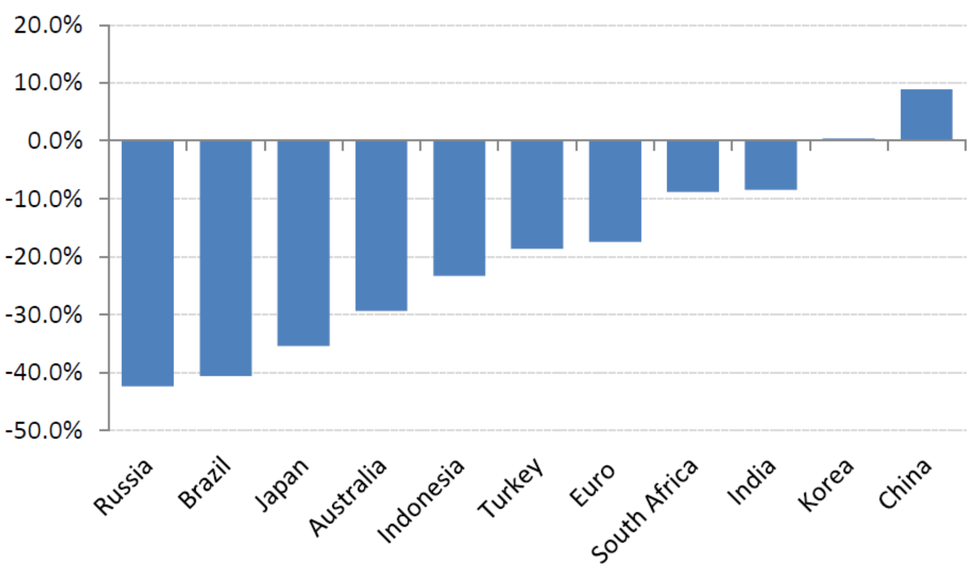


Figure 7: Select Currencies Against the U.S. Dollar Since 2011[32]



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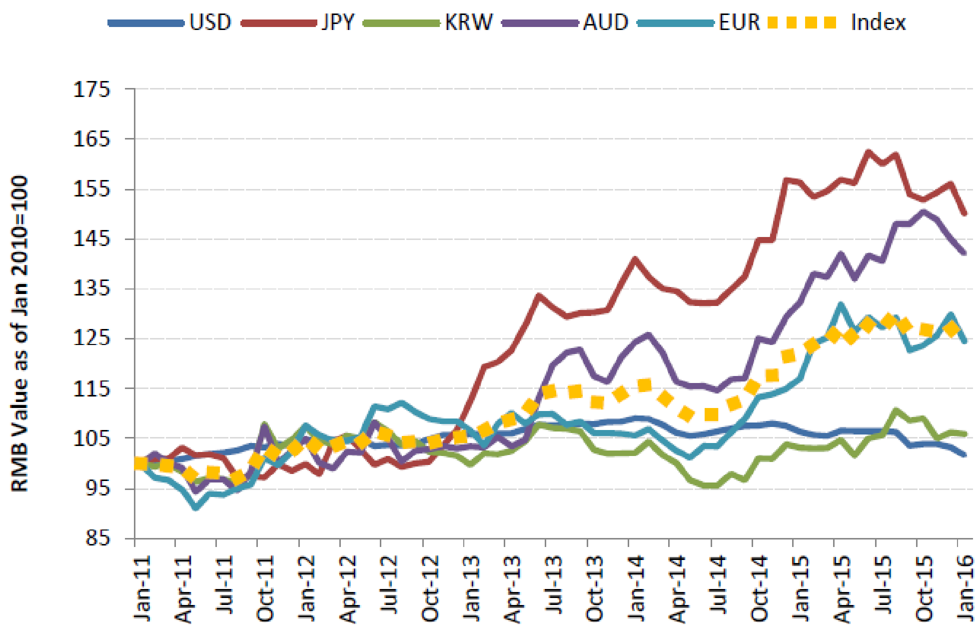
[31] BIS debt service ratios statistics, November 2015.
[32] Carlyle; Data obtained through Bloomberg, February 12, 2016.

Figure 8: RMB Exchange Rates, Scaled to January 2011[33]



[33] Carlyle; Data obtained through Bloomberg, February 12, 2016.

PANEL I QUESTION AND ANSWER

HEARING CO-CHAIR CLEVELAND: I'd actually like to begin by asking you to elaborate a little bit on the foreign exchange reserves. As I understand the banks in China are all denominated in renminbi. The debt is renminbi. So where is this $100 billion hemorrhaging, can you talk about what the Chinese government is doing to address that?

DR. THOMAS: Sure. Well, first, there is $1.1 trillion of liabilities in China that are dollar denominated. It's only about five percent of the outstanding stock so this is mostly RMB denominated debt in China, but there is that amount. So I wanted to make that clear.

HEARING CO-CHAIR CLEVELAND: You said the 1.1 trillion represents five percent?

DR. THOMAS: About five percent, yeah, a very small, but still 1.1 trillion in absolute terms.

In the third quarter of 2015 when there was the first, the surprise devaluation in August, the data from the IMF suggests that about 68 percent of the decline in foreign exchange reserves was attributable to debt repayment of U.S. dollars. So domestic businesses thought to themselves we don't want to have an asset liability mismatch. We have RMB denominated revenues. We have dollar denominated liabilities, again, for this segment. We better repay those dollar liabilities today, and that was the main source of the money, taking money from the SAFE or People's Bank of China, the dollars being used, converted and then used to repay dollar denominated debt.

About one-third was money that is escaping. So it's RMB that is being converted into dollars by, generally through foreign trade. That's where the loophole--capital controls generally inhibit the, you know, up to $50,000--beyond $50,000 the ability to make portfolio shifts. But foreign trade and just how large the trade account is in China provides significant loopholes with respect to invoicing, you know, claiming that you have more exports than you do. Those sorts of activities allow one to convert RMB into dollars, and so that's largely where the foreign exchange depletion is occurring.

HEARING CO-CHAIR CLEVELAND: So that's how it's occurring. How do you see the government responding or managing that slide or stopping it? I mean what do you see in terms of policy options or interventions?

DR. THOMAS: The main policy response to date has been a tightening of capital controls and closer monitoring of trade accounts and trying to ensure that there is not any over-invoicing so as to accumulate dollars, and that this has been moderately successful.

I think that, you know, again, it's the great challenge here is you have two factors. Number one is this latent demand for foreign assets because of the history of capital controls meaning that households and just portfolios generally are not sufficiently diversified, and then number two is this sense today, since August that there is an imminent further devaluation. So it's getting out before that move occurs. There's a strong incentive.

So I think until there's more clarity from the government, and I think that that means, you know, when you think about the situation in the United States, we're used to essay-length FOMC statements. We're using to seeing minutes of the FOMC meetings six weeks later and then, of course, all the speeches that occur on a weekly basis. So we're used to communication about strategy to an extent that those obviously are absent here.

So I think beyond what's been done to date probably the biggest policy change is not so much in the policy implementation itself so much as fuller communication to market participants and to Chinese households about what's likely to occur.

HEARING CO-CHAIR CLEVELAND: My time is up, but I want to ask you when you talk about that six-week window in terms of deliberation and communication, what's your assessment of the process that goes on behind the scenes in terms of trying to manage monetary policy?

I take the view that there may not be a lot of communication because there may not be a lot of clarity in terms of how we are going to fix this or what we are going to do. So I'm curious about your and Mr. Turner perception of, do we have any clue whatsoever about what's really going on in terms of Xi and his inner circle in terms of making these decisions?

DR. THOMAS: No, I don't have a great sense. I would say a couple of things. Number one, I think that there's likely to be disagreements among officials, you know, some, I think, that want to have higher real interest rates and tighter monetary policy so as to force larger structural reforms. That if you have high real rates and there's increasing distress and default pressure, that that's going to force policymakers to make the tough decisions. So that's a source of stress.

Secondly, you know, I think that there is this issue about, you know, making a decision on the exchange rate or the broader monetary policy framework that is viewed as being forced by speculators or as somehow external pressure, and I think that that is a complication that's arisen as you see more and more news in the press about fund managers taking positions in foreign exchange seen as unsustainable, and I think that that is a real complication to decision-making because of the sense--

HEARING CO-CHAIR CLEVELAND: I'd like to follow-up, but my turn is over.

HEARING CO-CHAIR WESSEL: Mr. Turner, do you have a follow-up? Mr. Turner, if you have since Commissioner Cleveland--

MR. TURNER: I think what the doctor has just said reflects our view as well. I think that there are real debates going on internally, and I think part of those debates have to do with perhaps being somewhat surprised by the reaction of the markets as they take steps. For example, closing off the liquidity in some of the offshore trading of the yuan, that happened rather quickly once they observed what that was doing to their currency.

So I would echo what he said that there's quite a bit of debate going on, and frankly they're trying to figure out now more than they have in the past probably how the markets are going to react to the moves that they make.

HEARING CO-CHAIR WESSEL: Chairman Shea.

CHAIRMAN SHEA: Thank you both for your testimony.

A few years ago, there was a meme going around that China is America's banker, and we have no leverage over China, can't pressure them, and Hillary Clinton, I think, got the meme going with a statement to that effect, but if you look at that, I think that theory is wrong. I mean my view is that's wrong. If you look at the debt that China holds, it's less than seven percent of total U.S. debt so it's significant but not an overwhelming portion.

Now with the decline in the Chinese economy, there's another popular meme going on that China and the U.S. are inextricably linked economically, and so when the Chinese economy goes down, the U.S. economy goes down. You see that reflected in popular sentiment, which is reflected in the U.S. stock markets.

But then you look at the statistics: U.S. goods exports to China were eight percent of U.S. total goods exports, significant but not overwhelming; U.S. goods imports from China were $481 billion last year, or 22 percent of U.S. goods imports, very significant but not 50 percent or 60 percent. If you look at FDI, our U.S. FDI flows into China were, accounted for only 1.5 percent of global FDIs into China. If you look at Chinese FDI into the U.S., it was only 2.2 percent of total U.S. FDI into the U.S.

So my question for you is, is this statement that this feeling that this Chi-America thesis, is that exaggerated? And it's particularly relevant today.

And the second question is, is it really smart for the United States to be pursuing greater economic integration with China as it's being led by someone who sort of fashions himself as the second coming of Chairman Mao? You have incredible exercise of control over some aspects of the economy, but in other aspects, it's like the wild, wild West. There is no transparency to talk about. No communication. Economic statistics are murky at best.

So is it really smart for us to be pursuing a strategy of greater-linking our economy to that of the Chinese economy? So those are two questions. A bit of a ramble. I'm sorry.

HEARING CO-CHAIR WESSEL: Mr. Turner, if you want to start?

MR. TURNER: Sure. Well, I will certainly be happy to address the first question. I'm not sure I want to weigh in on the second. But the first question, in terms of how inextricably linked the economies are, I think there are many ways to look at that. There are the direct statistics that you cite which certainly indicate that the level of inextricability is probably not as great as people think.

Having said that, many of our clients have significant operations in China. Many of our U.S. clients have significant operations in China. They use that as a manufacturing base in many cases to serve their customers around the world. So there are levels of integration that go beyond I would say the surface statistics.

And the second thing I would say is, whatever happens in China, it's not just the direct relationship between the U.S. and China that is important to understand. It's the fall-on effects. China is the most important trading partner to a number of relatively significant economies, and any fall-on effects from those bilateral relationships certainly will come and affect the U.S.

So that would be my answer to the first one. I think we probably are a little more inextricably linked than perhaps the surface statistics would indicate.

CHAIRMAN SHEA: But less so than the popular sentiment?

MR. TURNER: Yeah. I don't have a good view of the popular sentiment so yeah.

CHAIRMAN SHEA: Or the CNBC sentiment.

MR. TURNER: The CNBC sentiment, sure, I can agree with that. Okay.

DR. THOMAS: I would just say that I think that the integration with respect to the manufacturing sector and the global supply chains is fairly great, and again I think that this impact on industrial input prices is very significant, and that's where I see the biggest effect domestically in terms of why has the--you know, something that's fascinating to consider is that U.S. domestic auto production grew at something like nine percent last year.

It was because of the surge in purchases of SUVs, light trucks, crossovers, gas-guzzling vehicles, where our domestic manufacturers have a huge, a huge edge, but yet industrial production fell at 1.8 percent through the year. You know, if you had told me five years ago that U.S. domestic auto production grew at that pace, I would have guessed that overall industrial production must have grown at four and five, 4.5 percent because auto is the traditional bellwether. And that, of course, didn't happen, and the reason is because of this fall in energy prices and the collapse in industrial orders for equipment used in energy exploration and development.

So I think that that's a very significant area where declining demand for China or just we've become built on extrapolation of demand for these industrial inputs in China. In the case of oil, it's really distillates, diesel fuel, and the like used in industrial processes. So that's led to linkage.

I think when you look at the reaction of our stock market to their stock market moves, that doesn't make sense to me. I think to that point, it doesn't, you know, I think it's just a contagion because of fear and perhaps misunderstanding about the economic linkages. So I fully agree on that point.

And then finally I would just say that the future linkages, you know, China is, household spending in China last year was almost four trillion U.S. dollars. It grew at about nearly 400 billion U.S. dollars, just the growth. So the growth in spending in the household sector is the size of several major economies globally, and I think that given the incremental demand from the household sector is that large, it's going to naturally lead businesses to think about how they can take, you know, how they can grow their business in China, and that's true globally.

When thinking about management teams and how, what their strategy is for growth, it almost always includes some way to increase their presence in China, if not physical presence, at least, you know, final sales there. So I think that in some sense that's unavoidable, and that is not a U.S.-specific phenomenon. That's just globally when we talk to management teams in Japan, management teams in Europe, you know, a strategy for China is something that occurs repeatedly because of
the raw numbers of the growth contribution. CHAIRMAN SHEA: Okay. Thank you.

HEARING CO-CHAIR WESSEL: Thank you.

Since Chairman Shea chose to begin with a disagreement with the Democratic front runner, I think I won't spend much time disagreeing with Mr. Trump's analysis of the U.S.-China problem. So later we'll talk about what your view might be on that.

Let me bring this back down to the advice without being specific you're providing to portfolio investors and others. So with the overcapacity issue, which is steel, aluminum, cement, glass, as I recall from Financial Times, it's anywhere between 14 and 17 sectors.

And I believe it was several months ago, the Chinese leadership talked about taking as much as between 100 and 150 million tons, metric tons, offline over five years while according to the, I think it was testimony we'll receive later, that it's over a 400 million metric ton overhang.

What should U.S. companies be doing who are in the market in any of those--and I understand there aren't too many U.S. steel firms operating in China. There are aluminum firms there. Are you telling them that they can withstand the four or five year overhang with the kind of investment metrics that our own markets expect for them, the returns on investment, the ROIC, and the other metrics that markets demand?

When some of us were in China early or in July of last year, a number of U.S. companies talked about as the slowdown was occurring, they were finding that U.S. firms were getting squeezed a bit more because the Chinese leadership was interested in making sure indigenous firms benefited or survived first.

So what's the advice to U.S. companies as they look at potentially further investments in China or whether they continue to maintain their investments there, whether, you know, they should ride it out, whether they can ride it out, and what does it mean for their investments here?

Mr. Turner, if you want to start?

MR. TURNER: Great question. This is one we wrestle with everyday with our clients. So first I will say that the overcapacity extends beyond just the sectors that are in the press. And so in nearly every sector that we look at and that we work in in the market, there is overcapacity to varying degrees.

And, secondly, I will also add that even in sectors that have 30 or 40 or 50 percent excess capacity today, we're still seeing announced new investments being put in the ground. And so that obviously causes us concern because there is a calculus that is going on that we don't understand given our return on investment mindset.

So having said that as background, what are we telling our clients? I think a lot of that depends on the particular sector and the particular players that are in each sector, if it's a sector where there is clearly an announced plan, where there's a belief that restructuring is going to happen, and I think the two that keep being talked about over and over again are steel and coal.

They seem to be focused intently on those so the fact that they've said it now several times certainly suggests that maybe they're serious about it. There we would say, okay, there's something going on there that's going to be helpful to any participant in the market.

In other sectors, it really depends upon the situation. Look, our view is long-term. If you're in the market and you have capacity in the market, it's a good market to play in as a U.S. company for the reasons that Dr. Thomas mentioned as well. The consumer is a burgeoning consumer. Spending is increasing. So long-term, you know, we're fully committed to telling our clients to stay the course.

The issue is can you last the four or five years? And that's where it depends upon even our individual clients and their appetite for living with three, four, five years of losses. And sectors that are dominated by or have heavy influence from some of the state-owned enterprises, those create different kinds of discussions than sectors where you don't have as much of that activity. So it really depends upon the situation, but it certainly is an issue that every one of our clients is thinking about.

HEARING CO-CHAIR WESSEL: As a quick follow-up, maybe a quick follow-up, if you look at the China market, and you talk about tier one through four cities.

MR. TURNER: Yes.

HEARING CO-CHAIR WESSEL: And from what I have seen, we have done, U.S. companies have done a fairly good job in tier one and two tier cities, but have done very little in tier three and four. Are there differential growth rates or are the tier three and four cities potentially, to the extent we have better logistics, distribution, et cetera, potentially a pressure release valve?

MR. TURNER: Yes. So in many of the sectors that we participate in over there that we look at, the growth is really happening now in tier three and four cities. There's still development happening. Tier one and even some of the bellwethers--I think I mentioned this in the note--automotive in places like Shanghai and Beijing, it looks more or less like a Western market in terms of growth rates that we see.

But tier three and four cities, in particular, we do see opportunities for growth. Now in some sectors, though, depending on whether it's a consumer sector or B-to-B sector, the local brands tend to have established themselves a lot earlier. So the challenge for a U.S.

participant is really fighting that battle, but it's certainly a growth area, a growth opportunity, for our clients.

HEARING CO-CHAIR WESSEL: Dr. Thomas, did you have a comment or two?

DR. THOMAS: I would just say that our recommendation is to be very, very cautious with respect to the industrial sector, and we've very much taken a wait-and-see approach with respect to restructuring, and we have those ideas about what we'd like to see and sort of preconditions for further investment or further expansion among portfolio companies and investment.

I think that the, if you do have capacity, don't shut it down or destroy it, but again a great deal of caution with respect to industry, and, you know, mining, heavy manufacturing, property development, those, and then related materials are all very much state dominated. So those are sectors where you have to be very careful because there are ultimately political decisions that are going to be made about how to deal with excess capacity in those areas. It's going to be not entirely market outcome.

And then I would say that very much interested in expanding investment with respect to health care, technology, media, telecommunications, advertising, and then logistics, e-commerce, warehousing. So those are the areas where we're very interested in advising portfolio companies to seek expansion, see lots of opportunities for growth, and then again in the industrial sectors that you mentioned, it's very much, very cautious.

HEARING CO-CHAIR WESSEL: Thank you.

Commissioner Tobin.

COMMISSIONER TOBIN: Thank you, both.

Mr. Turner, I have a question for you. I appreciate the practical perspectives that you've given, and you in your testimony shared pointers for the Western businessperson.

MR. TURNER: Yes.

COMMISSIONER TOBIN: And I know you have Fortune 100 companies across a range of different industries. I'd like to zero in on the automotive industry because it is both industrial and consumer oriented. You commented earlier that the Chinese consumer is a robust consumer and an aspirational consumer. A few years ago, we heard the concept of 300 million people entering the middle class.

How have the recent turns and shifts in the economy affected that automotive industry and what are you advising American companies in that large industry?

MR. TURNER: It’s an interesting space, and I won't speak with full facts here, but I'll do the best that I can. You know as we look back over the past year, what's interesting in terms of what happened with automotive is when the stock market crashed in June, there was a rapid deceleration in automotive sales, and because this is such an important, important part of the economy for the government frankly, they came in--and I don't remember the exact time--in the fall with a tax break especially on small vehicles, and by the end of the year, we suddenly saw the automotive space burgeoning again and growing at double digit rates.

COMMISSIONER TOBIN: Just in a few months?

MR. TURNER: Just in a handful of months. Just on the basis of an incentive that was put in place, a tax incentive that was put in place.

So the consumer is very reactive to those kinds of incentives, and that's why we tell our clients, you really have to pay attention almost everyday because individual sectors can, especially ones that are being paid attention to, can turn very quickly, and so I remember discussions in the middle of last year where there was concern about is this now the turning point for the automotive sector in China? And by the end of the year, the discussions were completely different.

So paying attention to incentives that are put in place by the government to spur the consumer, and the consumer will react very, very quickly. So we see again a very robust consumer and as it relates to automotive.

COMMISSIONER TOBIN: So there is sustained interest in purchasing?

MR. TURNER: Well, for now, yes. For now, yes. I mean, look, I think, to us, the challenge becomes as you're trying to move away from an investment-driven approach to driving growth, and some of that moving away requires restructuring that forces job losses, you know, the robustness of the consumer may be impacted as some of those decisions are made.

But the fact is that, and Dr. Thomas talked about the figures before, this is a consumer that is spending ten percent more year-on-year in aggregate, and they also have a very, very high savings rate relative to the West. So there are reasons for us to believe that there is still room to tap into a robust consumer in China.

COMMISSIONER TOBIN: Dr. Thomas?

DR. THOMAS: No, I would agree, the household sector is very lightly leveraged, too. On the whole, household leverage is about 30 percent of GDP, slightly more. So less than half advanced economy levels. So that makes one feel more comfortable that there is not only spending out of current income but also the capacity to pledge future income to increase purchases today.

We tracked household spending through discretionary travel spending. We look at lodging, hotel lodging, and growth continues to be in the range of about nine percent in real terms so very strong. Outbound tourism spending is also very strong. So these, households generally, this is where you see the first pull back in the concern about future income or job loss. It's these discretionary indicators, and thus far, they remain strong. So I'm fairly optimistic about the present.

But then, also, again, given the high savings rate, 35 percent savings rates in the household sector, you know, the issue is just there needs to be an increase in labor income. The labor income share of GDP needs to grow, and that means that state-owned enterprise retained earnings need to fall, and that's really where most of the growth is going to come from prospectively, but I think that there's reasons to be optimistic about the household sector.

COMMISSIONER TOBIN: Thank you, both.

HEARING CO-CHAIR WESSEL: Vice Chairman Bartholomew.

VICE CHAIRMAN BARTHOLOMEW: Thanks very much and thank you, both, for appearing today.

It's really interesting testimony. Mr. Turner, I just have to note, I don't know how many times you appear somewhere, and people are just slightly disappointed that you're talking about monetary policy and not chocolate.

[Laughter.]

MR. TURNER: Yes, that happens all the time, in fact. So it started with my kids when they were young.

[Laughter.]

VICE CHAIRMAN BARTHOLOMEW: Thanks so much.

I also find it interesting that in so many discussions about monetary policy and what's going on that we have these conversations without acknowledging right up front that China is not free market capitalism, that it is a state-managed economy, and that is indeed the source of many of the problems that they're facing.

And I wanted to follow up a little bit on a question that Robin was asking but talk specifically. You know when we look at either their inability or their unwillingness, I mean they were not able to manage the stock market volatility that's happened, and whether that's a question of they just don't know what to do or whether they are unable or unwilling to do what needs to be done. But I wanted to talk specifically about reform of the banking sector because I was listening to you, and I was thinking, you know, in 2001, Gordon Chang wrote the Coming Collapse of China, and that was one of the places where people really started talking about the nonperforming loans. It's 15 years later now, and we're still talking about nonperforming loans.

So, again, is it that they are not willing to undertake these reforms? Is it that they are unable to do it or that they just don't know what to do?

HEARING CO-CHAIR CLEVELAND: Or they don't have to?

VICE CHAIRMAN BARTHOLOMEW: Well, that's another question.

MR. TURNER: I'll weigh in, but I'm sure the doctor has a much better perspective on this. As we look at it, first of all, it is a very localized financial sector so unlike some of the crises we've seen in other economies around the world that had large amounts of dollar denominated debt, we don't see the same dynamic necessarily with China.

The official statistics on nonperforming loans are actually in aggregate very low, but we see the growth in non-performing loans coming. In aggregate, the official statistics would suggest that the level of nonperforming loans is actually pretty low. However, you have to consider the fact that there is a large non-official banking sector, which, you know, as part of the anti-corruption push is being cracked down upon.

But our view at this point is they haven't yet had to take on this issue despite the fact that as we look at numbers and see debt at 300 percent of GDP, it certainly causes us concern and worry. And the growth in the nonperforming loans causes us concern and worry, and we would expect that at a certain point in time, they're going to have to take on the hard actions to restructure the financial sector.

So far in the interest of continuing to achieve the 6.5 percent growth target, the financial sector is continuing to lend money and the government is continuing to take the policy actions that allow them to do that. So our view would be, yes, at some point they have to take this on, but they haven't had to yet.

VICE CHAIRMAN BARTHOLOMEW: Dr. Thomas.

DR. THOMAS: Well, I would say that a key problem in the Chinese economy, of course, is knowing who the ultimate obligor is for the borrowing. Who's ultimately responsible for the payments, timely payments, the guarantees?

And I think that that, the moral hazard issue is a key contributor to the very rapid growth in credit. And that creates a challenge because there's significant fiscal space. When you look at the central government's debt-to-GDP ratio, it's relatively low, even including those portions of local debt. It's, you know, 48 percent of GDP. So there is significant space but certainly not enough space to guarantee everything. So there are very hard decisions that need to be made.

And, then, of course, speaking about the foreign exchange reserves and ultimately being finite and the amount of space. So this is an issue that as the indebtedness grows, the capacity to deal with the problem ebbs, that at some point, it's not that they're not forced to deal with it, that they may not be able to deal with it in a way that leads to as good an outcome for China in the global economy as if they had dealt with it five years ago.

So it's a source of concern. It's, I don't view it as getting away with the issue. I think it's prolonging the pain, ultimately making the scale of the problem larger. So it's certainly a source of concern.

I would also just note that, you know, when you think about the stimulus that occurred in 2008, 2011, financing that through the banking system was really unfortunate. It was a retrograde action. I think that steps had been made through the creation of asset management companies to deal with nonperforming loans in the '90s and the past decade, and the decision to, if that were financed entirely through bond issuance from the Ministry of Finance, I think we'd have a very different perspective on the program.

So that that was unfortunate, and it was a step back in some sense, but again I think the sooner that these problems are addressed, the ultimate, the smaller the size the ultimate resolution costs.

VICE CHAIRMAN BARTHOLOMEW: Robin has a comment.

HEARING CO-CHAIR CLEVELAND: What does "soon" mean to you? When you say the sooner they--

DR. THOMAS: I'm sorry?

HEARING CO-CHAIR CLEVELAND: You said that the sooner they address this, that they're prolonging the pain, the sooner they address this, the better. What does "soon" mean? "Soon" to Chinese is a very different time line.

DR. THOMAS: Well, I think that again, it's bending the curve, and that means that immediately action should be taken so as to, you know, slow the pace of debt accumulation. Also, again, this is, but this issue with moral hazard and, you know, there's a lot of SME, you know, as I mentioned in the testimony, 83 percent of indebtedness in the corporate sector is in three industries--mining, manufacturing, property development. 78 percent of indebtedness is state-owned enterprises.

So people think that money is so easy to come by. We have portfolio companies in other firms that we look at in the SME sector that get quoted 16, 18 percent interest rates. So this issue is not simply an NPL problem. It's a need for broader financial sector reforms.

HEARING CO-CHAIR WESSEL: Commissioner Brookes.

COMMISSIONER BROOKES: Thank you, and this is for the panel, and it may be beyond your portfolio, but many of us are watching with interest what's happening in the South China Sea, and it was just reported that the Chinese have now deployed some fighter aircraft to Woody Island. They've placed a surface-to-air missile there, radars, et cetera.

Do you see any relationship between the economic challenges in China and their foreign policy or national security policies abroad? Like I said, I understand this may be beyond your brief, but it's not unheard of historically for countries, especially if they are having domestic issues, that they perhaps involve themselves overseas in other issues that would detract attention from the challenges that the people are facing.

Thank you.

MR. TURNER: I would just say very briefly that that has occurred to us.

DR. THOMAS: I have enough trouble understanding the financial system and economics of China to speculate on that. Unfortunately, I don't want to dodge. I'd love to have a well-informed answer for you, but I'm afraid I don't.

CHAIRMAN SHEA: You guys should live a little. Come on.

[Laughter.]

HEARING CO-CHAIR WESSEL: We have several others though first. Senator

Talent.

COMMISSIONER TALENT: Yeah. I want to follow up on something Commissioner Tobin asked about consumer--but I also have a question for you, Dr. Thomas, and that's easier so I'll just say it right up front. As I recall, your statement doesn't deal much with the real estate bubble because evidently you don't think that's as big a problem as some of the other issues, and I'd like you to address that.

DR. THOMAS: [Nods affirmatively.]

COMMISSIONER TALENT: And then the second question, you both think that the Chinese consumer is a strength, and they're aspirational; they're spending more. But as the economy slows--and I think right now they have a fair amount of confidence in the government's ability to manage this transition and sustain growth--if they really enter securely into the middle income trap, and they get this deflation and very low growth, as we've seen in other countries, how likely is it that that consumer attitude will change as they feel less secure economically, particularly given the fact that I don't expect any big social safety net to be forthcoming in the near future?

So those are my two questions.

MR. TURNER: I'll address the second part of the question. Obviously, the first one was directed to Dr. Thomas. I think that we can even look in the past year and reflect on the consumer's reaction when it became either obvious or it became clear to them that perhaps things weren't going swimmingly; right? So the falloff in automobile sales after the stock market crash is a good indication of that.

Now when the consumer came back into the market at the end of the year on the basis of an incentive, you know, it also shows that they're willing to give the government some leeway in terms of how they're managing the economy. So our view would be that we certainly see signs that if enough wrong or bad things happen, there could be less of an appetite for cunsumers to exercise patience. But so far they react pretty quickly when the government steps in to try to rectify what they've done.

DR. THOMAS: When I think about industrial overcapacity and try to make estimates for the extent to which overcapacity exists, it's based on the presumption that property development has to shrink as a share of GDP. So when you think about property development, it's probably about 12 percent of GDP directly, you know, associated. You can get up to 20 percent depending on how you calculate and measure ancillary activity. So it's very significant, and it needs to shrink, and that's a problem.

But, you know, it's steel, concrete, and glass, the things that are used too in the property development where there's too much capacity, and these industries are based on an expectation for development growth that's not likely to materialize. So that's why I focus more on the industrial overcapacity.

I would say that with respect to prices that there's an issue also with the local government and the need to sell property to fund programmatic expenditure, and that's an issue, I think, of fiscal reform. How do local governments, provincial governments, how they can fund themselves as opposed to relying on property sales and creating this nexus between the property development sector and local government funding? That's a problem, but that's a fiscal reform issue.

When we think about real estate more generally, looking at office properties, looking at logistics, warehouses, we think that there are a lot of opportunities, and we don't look at prices as being wildly discrepant of those in advanced economies.

The issue is really this residential sector and the residential development. I would just note that I do feel a sense of caution in my own right because I think I saw bubbles in China in residential development 12 years ago. When you see lots of construction, essentially vacant cities, this clearly can't make sense, and then, of course, because of internal migration, then it got filled. So for that reason, my own experience, I do feel a little bit more circumspect about identifying this residential construction bubble.

But just in aggregate terms, I think the amount of construction that has taken place, you know, it looks like Thailand in the '90s, you know, Korea during that period of time, you know, Spain, 2006, just the raw number share of GDP, which I think is suggestive that too much residential development is occurring, and again I think when you look at the growth in prices in real terms, that's also a source of concern as well.

But, again, I focus my remarks and concerns on the capacity that this has created in a number of industries and the problems that are inherent if development spending moderates or actually returns to a more sustainable trend rate. That means that there's going to be a lot. There's much too much of these construction materials being constructed--

COMMISSIONER TALENT: So are you saying that you do think the real estate bubble is an issue, but you just include that in the general rubric of overcapacity? Is that basically what you're--

DR. THOMAS: That's right. And, again, I would very much focus it on residential, fixed residential investment, because when we look at outside of the residential sector, we don't see office buildings, we don't see warehouses, we don't see logistics facilities that are in data centers where pricing is somehow wildly out of line with what we see elsewhere in the world. So it's very much a residential phenomenon.

COMMISSIONER TALENT: Thank you.

HEARING CO-CHAIR WESSEL: Senator Goodwin.

COMMISSIONER GOODWIN: Thank you, Commissioner, and thank you to both witnesses on the panel for your time this morning.

Dr. Thomas, you mentioned that one of the key strategies that China has identified to eliminate or reduce this excess capacity is through business combinations or liquidations, a strategy that you indicated in your oral testimony was politically sensitive.

My question is how realistic and effective is that strategy proving to be when it begins to conflict with the Party and the state's interests in growing and protecting employment and ultimately stability?

DR. THOMAS: Well, I think, first of all, you have a situation where it's becoming clear or has become clear that capital accumulation, resource accumulation path for growth doesn't work because you're actually cannibalizing revenues from other businesses, and that's why you have this deflationary pressure, the sense that there's much too much capacity, that if you maintain operations or expand operations, you're actually hurting someone else. So there's already I think this internal tension based on the sense that someone else's capacity is necessarily, has implications for my sales, revenues, and ultimate profitability.

So for a period of time resource accumulation was a win-win, and because of the onset of deflation and difficulties, I think it's no longer the case, and I think that that changes the calculus in ways that actually allows for business combinations. You know, liquidations are certainly sensitive, more so, but business combinations that allow for two firms that perhaps cannot survive as stand-alone entities to be put together, perhaps taking some advanced, someone from an advanced economy or Western managerial background, inserting him or her as the CEO, and trying to make it work as essentially a private.

So it's SOE reform, and those are the kinds of business combinations that I think actually can make sense, again, based on the premise that there is this recognition that there's no longer these win-win scenarios. There are some, you know, that expanding capacity at my neighbor's actually has implications for my own well-being.

COMMISSIONER GOODWIN: Even the business combinations by definition to achieve the efficiencies that they would be intended to achieve would also occasion certain job losses.

DR. THOMAS: It would. No, there's no question that job losses are going to be part of the equation, and it's also--but this is also a--the two issues here I think that are of interest, first, World Bank World Development Indicators data suggests that the labor force has peaked, that we're actually on the other side of that. So that means that the political imperative to ensure that there is job growth, and particularly in some of these industries, is not as acute as it once was. So I think that provides some breathing room.

Secondly, the reason that household consumption is so small as a share of GDP is because labor income is too small as a share of GDP. And that's not going to be corrected by maintaining jobs in smelting and concrete and other industries. That means that they have to take the next step up on the value added ladder, and that means that you get into professional services, health care, technology.

So there has to be some willingness to accept job losses and displacement as a strategy to actually move to the service-oriented economy that leadership has been talking about for some time.

COMMISSIONER GOODWIN: Well, let me ask you about that. In the context of talking a little bit about the role that local governments play in these efforts to reduce excess capacity, it's my understanding that targets are established for companies to reduce or eliminate excess capacity pursuant to economic plans submitted by local governments.

And I suppose at that level, and even accounting for differences among the regions, the sensitivities to job loss and stability in the economy are more pronounced. So my question is wouldn't it be reasonable to assume that that would have an effect, if not the potential, to distort the figures that the local government provides and subsequently affect the elimination targets that are set?

DR. THOMAS: I think there are sensitivity--one issue that's of interest is when you look at the investment, what role does fixed investment play in job creation and actual consumption spending, you see wildly different estimates across regions. So in some regions, decreases in fixed investment, capital spending, property development have a very large impact on household spending and household incomes. In other areas, it's, they've sort of achieved that indigenous growth where there's more services, more jobs in other fast-growing sectors so it doesn't have as big of an impact.

So I think that there is, it's not just to say that the decision-making--it's not the decision-making at the local level. It's also specifically where this is occurring where there's going to be different sensitivities.

COMMISSIONER GOODWIN: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Bartholomew.

VICE CHAIRMAN BARTHOLOMEW: It's a question. Dr. Thomas, you were saying salaries need to increase, but I thought that the Chinese government has maintained some control on salaries, on what salaries are being paid. And the SOEs, are they, do they determine what the salaries are for workers in the SOEs?

DR. THOMAS: What I'm suggesting is that it's not--you can't just pay someone more so then you become uncompetitive in that industry. It's that the labor force has to change, and it has to change from manufacturing and other sort of industrial sectors, property development, to more service-oriented, and that's--when you have someone, a workforce that transitions from smelting to professional services, there's going to be higher income, there's going to be higher labor share of income, lower capital share, and that's the sort of transition.

If China is serious about making transition to a service consumer-oriented economy--

VICE CHAIRMAN BARTHOLOMEW: If it's serious.

DR. THOMAS: --that's what has to occur. You can't move to a consumer-oriented economy with labor income so low. When you think about household consumption expenditures of about 38 percent of GDP, why is that so low, it's partly low because household savings rates are so high, but the bigger reason is just that labor income share is too low, and that, again, that's a transformational issue. It's having services grow, having more employment in services, not simply paying people more.

VICE CHAIRMAN BARTHOLOMEW: Right. And then--sorry, Mike--an overcapacity, I mean I think some of what you're saying makes sense if the competition--I understand the competition on the lower end of manufacturing. But I'm thinking again of steel and aluminum and concrete, that the competition for these companies is not just within China, and as long as the Chinese government continues to subsidize those sectors, they do remain competitive regardless of the salaries that are being paid.

They remain competitive with our companies, for example, and they trounce us in these sectors. So I'm a little--I guess I'm just still a little unclear about the salary implication and overcapacity, but I think that's probably too complicated to try to deal with it here right now.

HEARING CO-CHAIR WESSEL: I believe we have run to the end of the panel, and I believe there are a lot of other questions we have, which I hope we will be able to work with you in the coming days maybe to get some other thoughts from you. We didn't touch upon the I believe it's 83 billion and pending transactions that Chinese companies have, are engaged in or seeking to engage in in the world economy. So your comments earlier about dividends and the need to pay those out, are they being retained to acquire, et cetera, and all of those issues?

So if you're willing to work with our staff and us going forward, we appreciate it and thank you both for your time. It's been a great panel.

We're going to take a short break as we move into the next panel and about we'll start again at 10:30--10:30. Thank you.

PANEL II INTRODUCTION BY COMMISSIONER ROBIN CLEVELAND

HEARING CO-CHAIR CLEVELAND: I think we'll get started. Our second panel will examine new developments in China's state sector and will focus on what changes, if any, are occurring in the reform ownership structures and activities of Chinese state-owned or state-controlled firms, both domestically and abroad, and in the context of Chinese state-owned, I'm interested in both--I think we're all interested in both centrally as well as regionally or local.

First, I'd like to welcome Mr. Paul Hubbard, who has traveled all the way from Canberra, where I spent many happy years in my childhood. He is a Ph.D. Scholar at the Australian National University's Crawford School of Public Policy and focuses on reform and governance of Chinese state-owned enterprises.

In 2015, he was a visiting scholar at Beijing's University National School of Development and is now on leave from the Australian Treasury where he has served in various roles since 2006.

He's recently published several research papers related to state-owned enterprise monopolies, discrepancies between national and local-level state-owned enterprises, and capital efficiency.

Next, we have Dr. Wentong Zheng. Dr. Zheng is an associate professor of law at the University of Florida Levin College of Law. He's written extensively on state capitalism and state-owned enterprises in China, including a chapter on institutional SOE reforms, in the 2015 book Regulating the Visible Hand? The Institutional Implications of Chinese State Capitalism.

Mr. Zheng earned his J.D. and Ph.D. in economics from Stanford, and his B.A. and M.A. from Renmin University of China.

And finally we welcome back Dr. Roselyn Hsueh.

DR. HSUEH: Hsueh.

HEARING CO-CHAIR CLEVELAND: Hsueh. Assistant Professor of Political Science--pardon me?

HEARING CO-CHAIR WESSEL: I'm saying it makes it easy.

HEARING CO-CHAIR CLEVELAND: Okay. At Temple University in Philadelphia. Professor Hsueh's current research includes a book manuscript under completion which investigates the mediating role of market governance and the relationship between global economic integration and development outcomes in China, India and Russia.

Her 2011 book, China's Regulatory State: A New Strategy for Globalization, examines the politics of market reform and evolving government-business relations across industries in post-Mao China. We welcome you back having testified here in 2012.

We thank you all for being here. We encourage you to stick to that seven minute limit because as you saw from the last panel, we have lots of questions. So I think we learn best with that engagement. So Mr. Hubbard, should we start with you?

OPENING STATEMENT OF MR. PAUL HUBBARD
SIR ROLAND WILSON PHD SCHOLAR AT THE CRAWFORD SCHOOL OF PUBLIC POLICY, AUSTRALIAN NATIONAL UNIVERSITY

MR. HUBBARD: Thank you, Commissioner, and thank you to the Commission for inviting me to come along here to share my research on Chinese state-owned enterprises, and, as the Commissioner mentioned, this is drawn heavily from my time working at Peking University and at the Australian National University.

Now, the title of this panel is "China's State Capitalism in a Global Context," and it's probably because many of China's largest and most important companies are large state-owned enterprises that make global headlines. But I'll just argue first that it's China's private sector that's, in fact, a bigger impact on the global economy.

I'm an economist so I can't talk without charts so I'll be referring to some charts that are attached to my written submission if you'd follow along with that.

So China's share of world manufacturing exports was just five percent when it joined the World Trade Organization in 2001. This share, as we heard this morning, has grown up to 18 percent by 2014. This Chinese export boom lowered prices for consumers all around the world and contributed to Asian growth through integration with regional supply chains.

Most things with the "made in China" tag on them are not, in fact, made by state-owned enterprises. This is largely a private sector success story, catalyzed by foreign investment that brought capital and technology into China's coastal regions. It connected them with global markets.

So when China joined the World Trade Organization, SOEs were responsible for 18 percent of Chinese exports, and today that has declined to less than eight percent.

So a comprehensive survey of 430,000 Chinese industrial enterprises in 2009 confirms that Chinese industry is dominated by the private sector, and 69 percent of the revenue that goes into resources, manufacturing, and utilities goes to sectors in which non-SOEs control a majority of assets, and these sectors are highly competitive.

Only 16 percent of industrial revenue goes to markets that are both concentrated and largely owned by SOEs, and the most significant of these are electricity, oil and tobacco. So these are the true state monopolies in China's industrial sector, but it's not a phenomenon that is unique to China.

In many countries, oil, electricity and tobacco either were or in some cases still are state-owned. Other industrial sectors which are dominated by SOEs, including steel and coal, are actually highly competitive.

Now given China's state monopolies in oil and electricity, it's not surprising that China's three largest companies are two giant oil conglomerates and the national electricity grid. The combined revenue of these three giants in 2013 was 1.3 trillion, which is roughly the same figure as the GDP of Mexico.

These are the largest of China's central SOEs, so-called because they are supervised and controlled by the central government's State-owned Assets Supervision and Administration Commission, or SASAC. The top leaders of central SOEs--the Party Secretary, general manager, and the chairman of the board of directors, if there is one--are also high ranking government officials. They're appointed and dismissed by the center. Central SOEs dominate other important fields like telecommunications and transport.

Outside of the SASAC structure, the central government owns the main banking and finance companies, tobacco, major media, and the post office.

All together, these central SOEs, these large business conglomerates with hundreds of subsidiaries, took half of the $9.2 trillion in revenue owned by China's top 500 companies in 2013.

And beneath the central government, the provinces own more than 100,000 SOEs, many of which have joint ventures with private capital, and these provincial SOEs amongst them control about half of all SOE assets, much smaller on average and much more likely to be active in competitive sectors.

Turning to investment in China and abroad, the SOE share of fixed asset investment in China fell from 58 to 32 percent over the past decade. The major sectors where China's SOEs still dominate investment largely relate to infrastructure and public utilities. This investment supports Chinese urbanization and further private sector growth. Importantly, investment in manufacturing, which accounts for one-third of fixed asset investment, is 88 percent private.

Now, the combination of a highly competitive private manufacturing sector combined with the effect of China's foreign exchange policy was to create large external surpluses over several years. This is what enabled China's going-out policy for overseas direct investment. This initially focused on gathering the resources that China needed for its industrialization.

According to the China Global Investment Tracker, 58 percent of large-scale investment abroad has been in energy or minerals, and because the largest investors in these sectors are SOEs, it explains the fact that about 70 percent of Chinese investment abroad has come from SOEs.

Now Australia has long been the favored destination for China's overseas resource investment, but even here the SOE investment is slowing and making way for non-state players. According to a University of Sydney-KPMG database, in 2014, a surge of private investment into commercial real estate saw China's non-SOE investment exceed SOE investment in Australia for the first time.

So I'll leave my testimony there. Thank you very much to the panel.

HEARING CO-CHAIR CLEVELAND: Thank you.

PREPARED STATEMENT OF MR. PAUL HUBBARD
SIR ROLAND WILSON PHD SCHOLAR AT THE CRAWFORD SCHOOL OF PUBLIC POLICY, AUSTRALIAN NATIONAL UNIVERSITY

Testimony before the U.S.-China Economic and Security Review Commission
China's Shifting Economic Realities and Implications for the United States

24 February, 2016

Mr Paul Hubbard,
Sir Roland Wilson PhD Scholar, the Australian National University[1]

I thank the Commission for the invitation to share my research on Chinese state-owned enterprises (SOEs). This includes research conducted at the Australian National University, and as a Visiting Scholar at Peking University.

The title of this panel is "China's State Capitalism in the Global Context". This is probably because some of China's state-owned enterprises are very large and powerful companies that make global headlines. However it is China's private sector that has had a bigger impact on the global economy.

Industry is predominantly private and highly competitive

China's share of world manufacturing exports was 5 per cent when it joined the World Trade Organization in 2001. This share grew to 18 per cent by 2014 (Chart 1). China's export boom lowered prices for consumers around the world, and contributed to Asian growth through integration with regional supply chains.

Most things with a 'made in China' tag are not made by SOEs. This is largely a private sector success story, catalyzed by foreign investment that brought capital and technology to China's coastal provinces, and connected them with global markets. When China joined the World Trade Organization, SOEs were responsible for just 18 per cent of the value of Chinese industrial exports, declining to 8 per cent by 2014 (Chart 2).

A comprehensive survey of 430,000 Chinese industrial enterprises in 2009[2] confirms that Chinese industry is dominated by the private sector. 69 per cent of revenue for resources, manufacturing and utilities go to sectors in which non-SOEs control the majority of assets (Chart 3). These are mostly highly competitive.

Only 16 per cent of industrial revenue goes to markets that are both concentrated and largely owned by SOEs – most significantly oil, electricity and tobacco. These are true state monopolies, but this is not unique to China. In many countries oil, electricity and tobacco either were, or in

[1] These are the authors' personal views.
[2] Survey data after 2009 has not been made generally available.

some cases, still are state owned. Other industrial sectors which are dominated by SOEs, including steel and coal, are competitive.

But China's largest companies are SOEs.

Given state monopolies in oil and electricity, it is not surprising that China's three largest companies are two giant oil conglomerates and the national electricity grid. The combined revenue of these three giants in 2013 was $1.3 trillion, which is the same figure as the GDP of Mexico.[3] These are the largest of China's 'central SOEs', so called because they are supervised by the central government's State Assets Supervision and Administration Commission (SASAC). The top leaders of central SOEs – Party secretary, general manager, and chair of the board of directors, if one exists - are also high-ranking government officials, appointed and dismissed by the center. Central SOEs also dominate telecommunications and transport.

Outside the SASAC structure, the central government also owns China's main banking and finance companies, the tobacco industry, major media and the post office.

Altogether these central SOEs, often large business conglomerates with hundreds of subsidiaries, took half of the US$9.2 trillion in revenue earned by China's top 500 companies in 2013 (Chart 4).

Beneath the central government, provinces own more than 100,000 SOEs, many of which have joint ventures with private capital. Provincial SOEs control half of all SOE assets, but are much smaller on average and are active in competitive sectors.

SOEs and Chinese investment.

Turning to investment in China and abroad, the SOE share of fixed asset investment in China also fell from 58 to 32 per cent over the last decade (Chart 5). The major sectors where SOEs still dominate investment relate to infrastructure and public utilities. This investment supports Chinese urbanization, and further private sector growth. Investment in manufacturing, which accounts for one third of fixed asset investment, is 88 per cent private.

The combination of a highly competitive, private manufacturing sector with China's foreign exchange policy, created large external surpluses. This enabled China's 'going out' policy for overseas direct investment. This initially focused on increasing the supply of resources needed for expanding investment. According to the China Global Investment Tracker,[4] 58 per cent of large-scale Chinese investment abroad since 2005 was in energy or minerals (Chart 6). Because of this, the largest Chinese investors have been the central SOEs that dominate these sectors. According to the head of SASAC, they account for 70 per cent of Chinese non-financial investment abroad.[5]

[3] (IMF World Economic Outlook, October 2015 Revision, 2013, $US1,262 billion)
[4] American Enterprise Institute and Heritage Foundation, China Global Investment Tracker 2016, https://www.aei.org/china-global-investment-tracker
[5] http://www.globaltimes.cn/content/927974.shtml

Australia has long been China's favored destination for overseas resource investment. However, resource investment is slowing, opening the way for more non-state players. According to a KPMG-University of Sydney database, in 2014 a surge of private investment into commercial real estate saw Chinese non-SOE investment exceed SOE investment in Australia for the first time.[6]

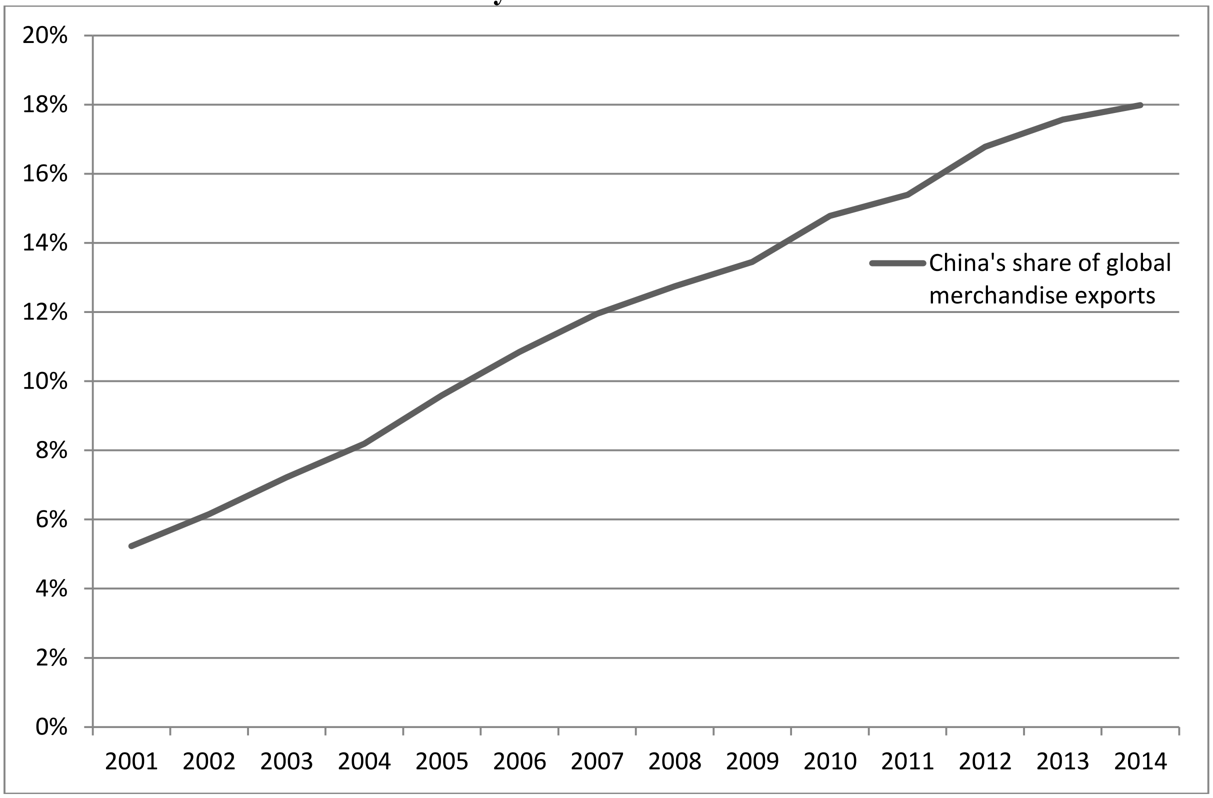
Implications for the United States

The prominence of SOEs in multi-million, and even billion dollar investment deals overseas, raises concerns about the global spread of Chinese 'state capitalism', even as SOEs' share of the Chinese economy is declining. Foreign investment into China helped align China's nascent private sector with the rules of the global trading system. Likewise, Chinese state investment overseas can be a channel to take back to China international standards for transparency, corporate governance and market behavior.

The United States, like Australia, has deep national interest in engaging with SOEs, not just to access capital, but because it provides an opportunity for Chinese state business to experience and be subject to the discipline of competitive markets, without special privileges, in well-regulated economies.

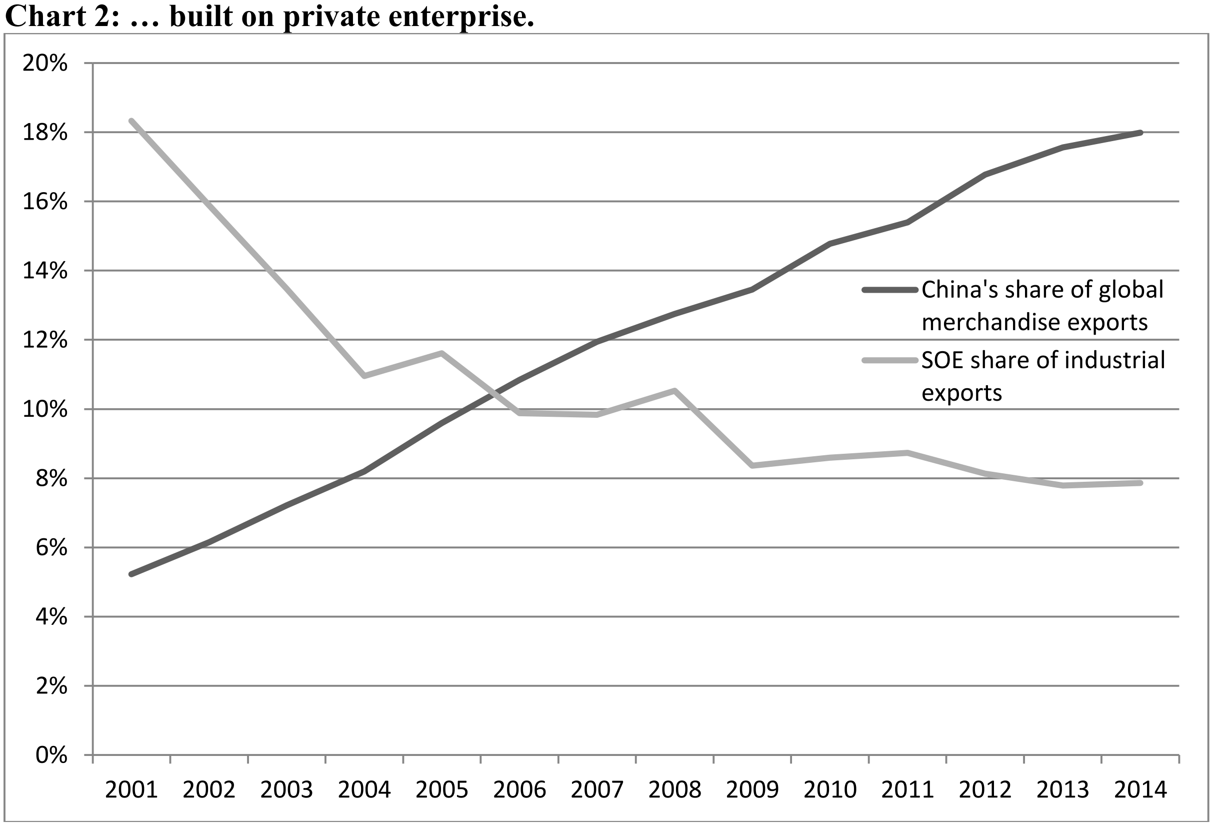
[6] KPMG and University of Sydney, Demystifying Chinese Investment in Australia: May 2015 update

Chart 1: China is the world's factory…



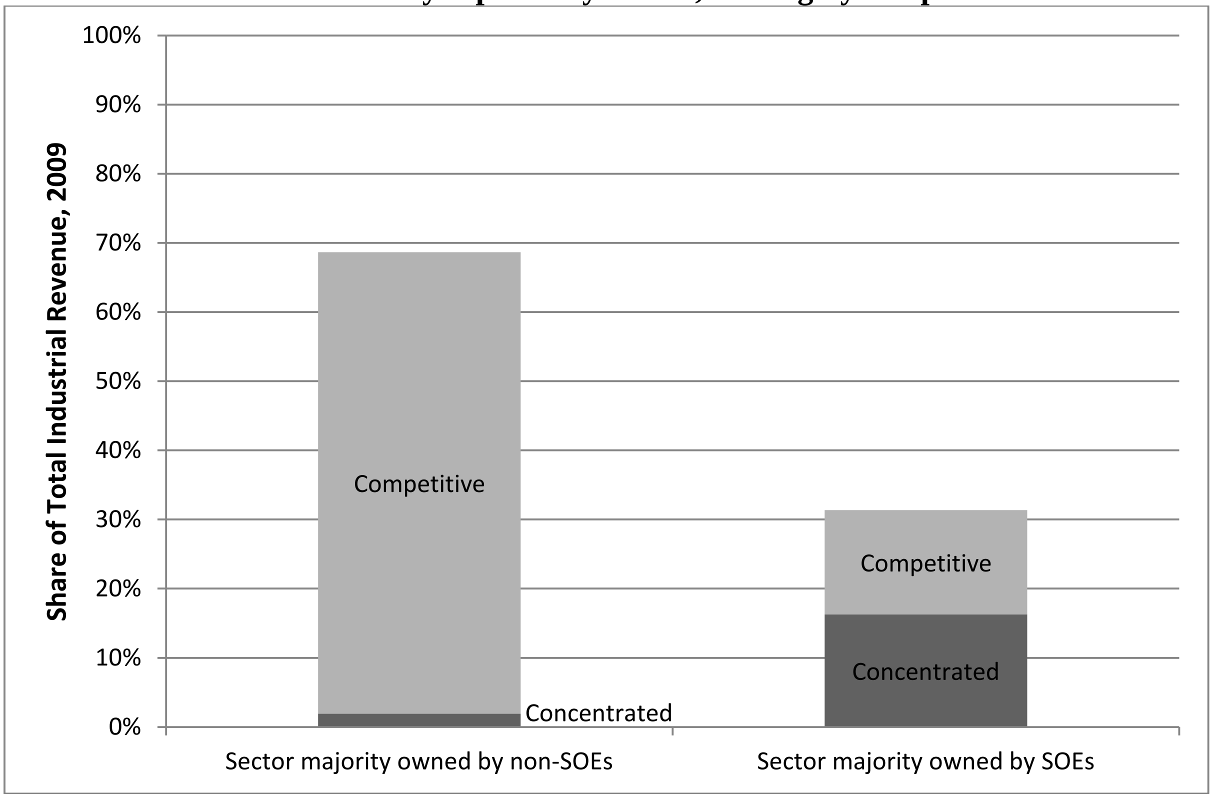
Source: World Trade Organization, Trade Statistics

Chart 2: … built on private enterprise.



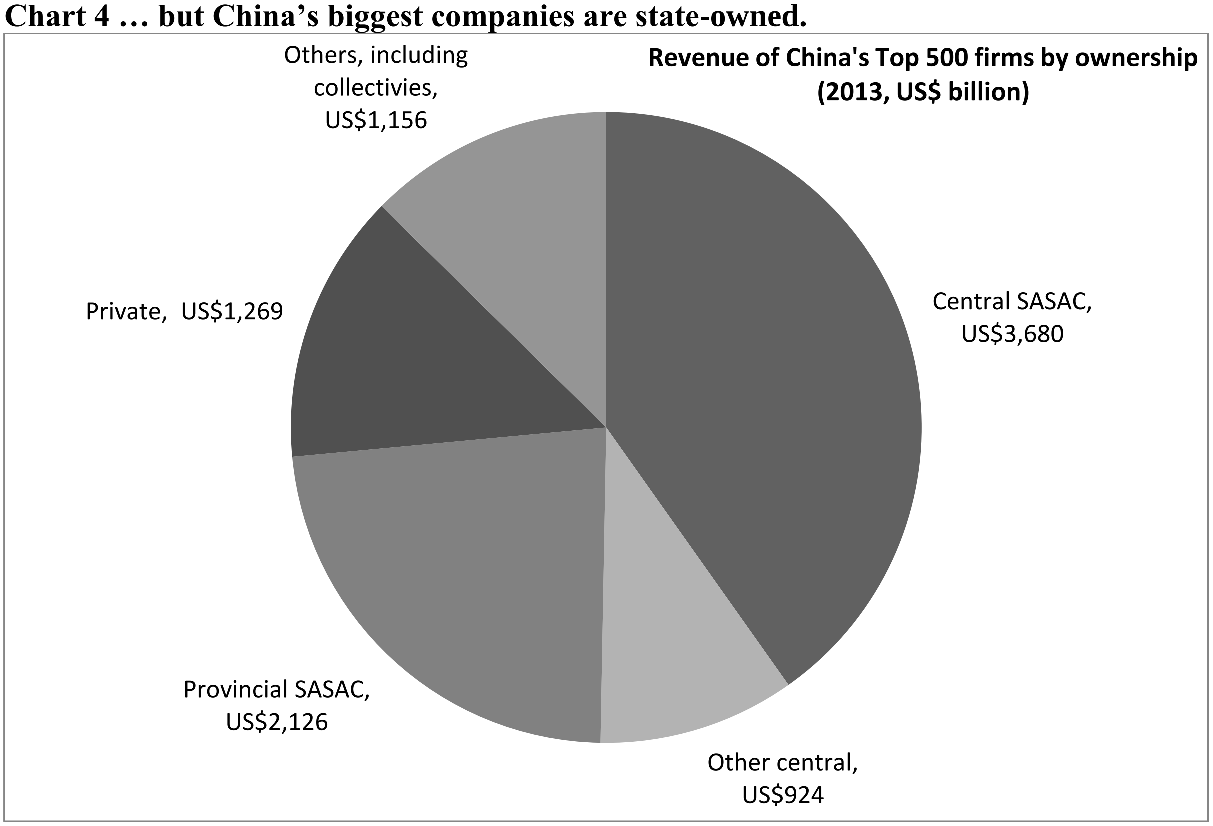
Source: World Trade Organization, Trade Statistics & CEIC China Premium Database

Chart 3: Most Chinese industry is privately owned, and highly competitive...



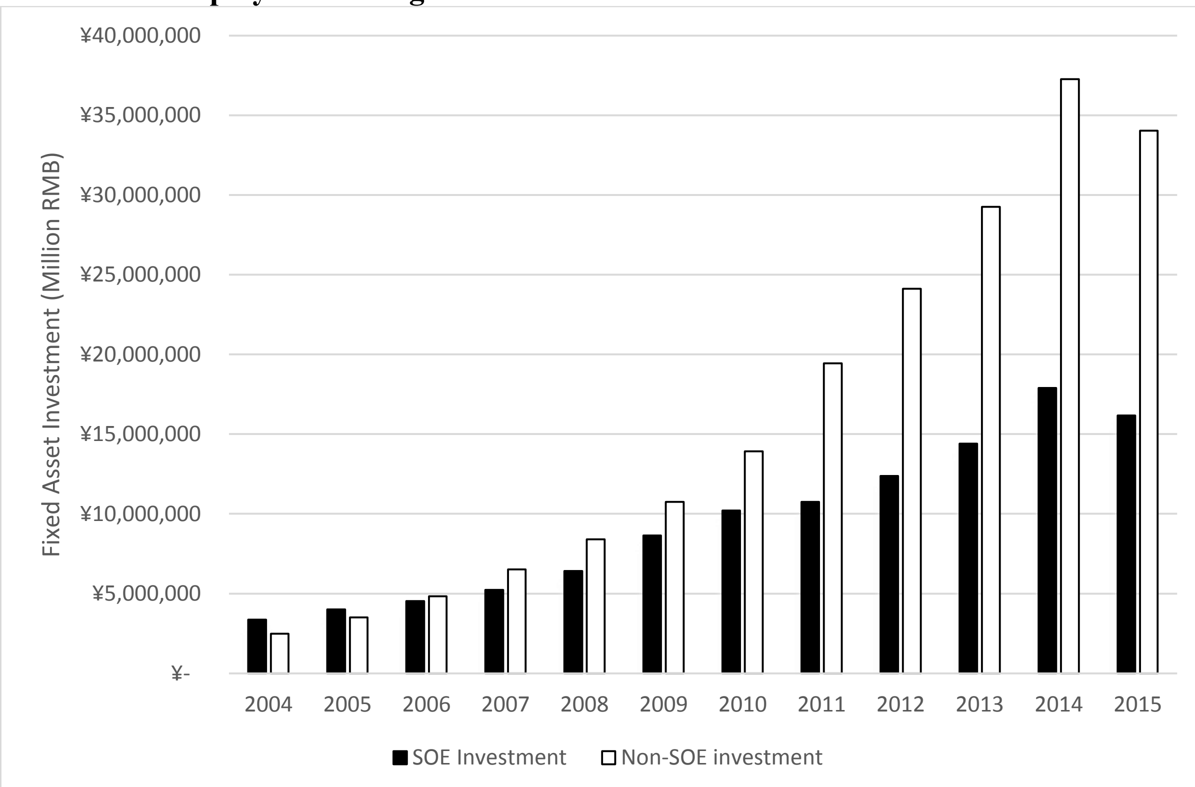
Source: Paul Hubbard "Where Have China's state monopolies gone?" China Economic Journal, Volume 9, Issue 1, January 2016

Chart 4 … but China's biggest companies are state-owned.



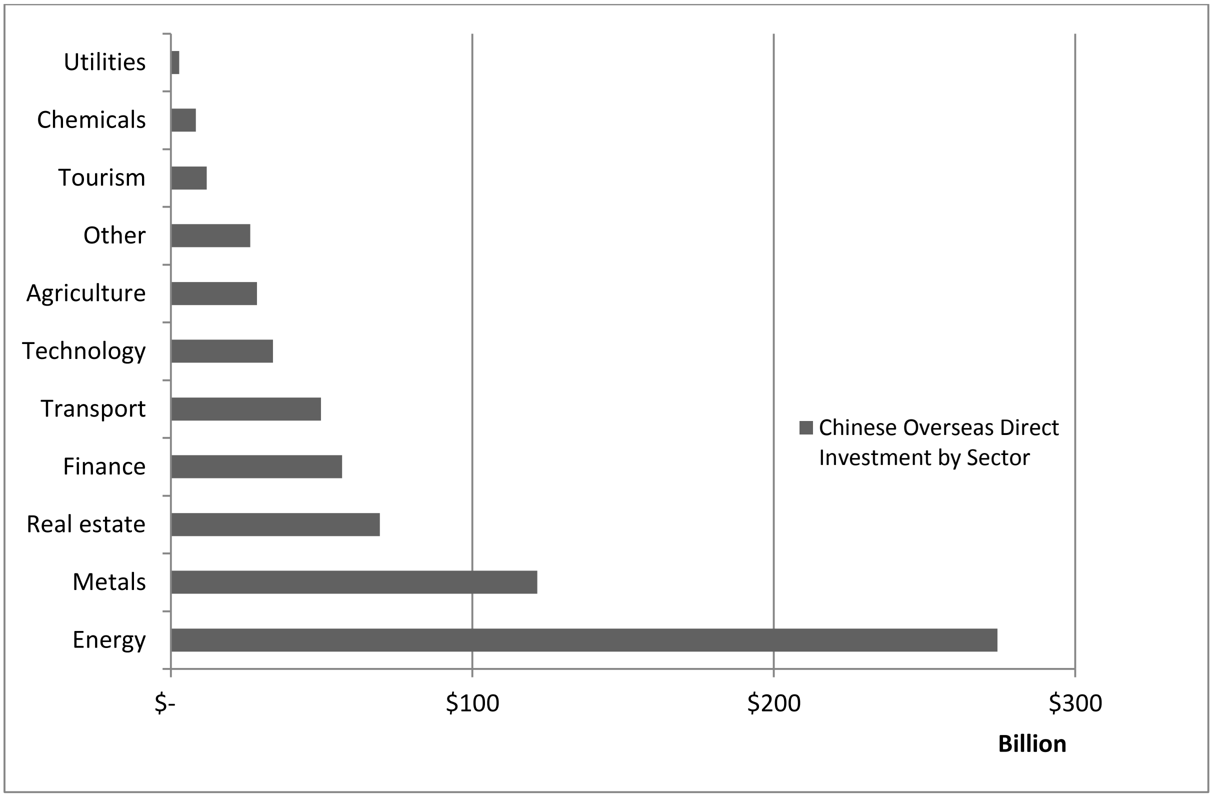
Source: Hubbard, Williams (forthcoming) "Chinese State Owned Enterprises: An Observer's Guide", International Journal of Public Policy

Chart 5: SOEs play a declining role in China's domestic investment…



Source: CEIC China Premium Database

Chart 6: … but have dominated China's investment abroad.



Source: American Enterprise Institute, Heritage Foundation, China Global Investment Tracker, January 2016

OPENING STATEMENT OF DR. WENTONG ZHENG ASSOCIATE PROFESSOR OF LAW, UNIVERSITY OF FLORIDA LEVIN SCHOOL

DR. ZHENG: Thank you very much, members of the Commission and staff. I very much appreciate the opportunity to share my views on China's state capitalism and its implications for the United States.

In my testimony today, I will address four different but related issues: first, the role of SOEs in China's economy; second, the nature of the Chinese government's control of SOEs; third, China's going-out policy and SOEs; and fourth, U.S. laws and policies on Chinese SOEs.

Let me start with a brief overview of SOEs in China. Before China embarked on economic reforms in the late 1970s, SOEs were the default arrangement in almost every industry. In the subsequent four decades that followed, SOEs in China were commercialized, corporatized and in many cases privatized. Today, China has an emerging private sector that has become a major driver of economic growth, employment and exports.

Now, that said, SOEs still play a very important role in China. They account for large percentages of industrial output, industrial assets, and employment, and in many of China's most important sectors, the so-called pillar industries, the largest firms there are all SOEs. For example, energy, transportation, electricity, telecommunications, banking and insurance. So if you look at the largest Chinese firms, you know, almost all of them are SOEs.

In 2015, 98 Chinese firms made their way to the global, Fortune Global 500 list. The top 12 of them were all SOEs. So that's a brief overview of SOEs in China.

Now let me turn to the nature of the Chinese government's control of SOEs. The Chinese government retains very important control over SOEs. In 2003, the government established SASAC, the State-Owned Assets Supervision and Administration Commission. SASAC exercises the government's rights as controlling shareholder in SOEs as well as regulatory power over SOEs. One of the things that SASAC has been doing in recent years is to from time to time to reshuffle top managers among SOEs.

The latest reshuffling of top managers of SOEs happened last August, in August 2015, in the telecommunications industry where the chairmen of the three largest Chinese telecommunications firms swapped positions. So this indicates tight control by the state over high-level personnel appointments at SOEs.

Now, in addition, China also has formal price control although the number of products and services that are subject to formal price control has dramatically shrunk over the years. Now only gasoline and certain natural gases and certain pharmaceuticals appear on the government-controlled price list.

But in addition to formal price controls, the government retains very important control over potentially all products and services through informal price controls. The government can exert their influence by having pressures on firms even though those pressures have no apparent legal basis.

Now that said, the state control over SOEs is not perfect. So most of the SOEs, for the most part, are commercialized entities now. The managers overseeing SOEs are human agents, and they respond to economic incentives. They have incentives to foster close ties with the government, to seek government benefits, and to resist government policies that are not in their best interest. So it is true that SOEs are overseen by government officials, but those bureaucrats are agents of the government themselves, and they need to be monitored themselves.

So without effective public monitoring, there is no guarantee that the bureaucrats will be able to implement policies that are in the best interests of the state.

So as a result of this so-called agency problem, the Chinese government actually controls the SOEs to a much lesser degree than its ownership interest in SOEs suggests. So this lack of effective control over SOEs can be observed throughout the Chinese economy. I can, I only give you three examples due to time limitations.

First, the government collects little or no dividends from SOEs; second, the SOE executives receive large amounts of private benefits or on-duty consumption, you know, even though the government has repeatedly tried to rein in such executive compensation. And the third, from time to time, the government fails to implement major operational or policy decisions at SOEs.

So really the nature of the government control over SOEs has changed. SOEs are no longer an alter ego of the state. They are for the most part commercialized entities that have their own incentives.

Now let me next turn very briefly to China's going-out policy and SOEs. As we know, since the turn of the century, China has been actively promoting foreign direct investment and SOEs have been a very important part of that story, especially SOEs in the energy and natural resources sector have been very active in acquiring foreign assets.

But it is important to note, however, that SOEs may not necessarily base their FDI decisions solely on political considerations. As I just said, SOEs for the most part are commercialized entities so they invest in overseas assets only if there is sufficient commercial justifications. So in my view, it is no longer appropriate to just presume all SOEs to be pursuing the political goals of the government.

Now, lastly, let me talk real quick about U.S. laws and policies. You know, the United States has many laws and policies that can be used to address the non-market behavior of foreign firms, including SOEs from China. You know we have trade remedy laws that would allow the U.S. to impose special duties on imports if the foreign firms engage in unfair trade practices, and we have the investment, foreign investment approval process in this country that enables the government, the U.S. government, to block any investment made by foreign firms that pose national security concerns.

In addition to those general laws that could be used against Chinese SOEs, we have laws and policies that target Chinese SOEs. For example, the recently concluded TPP, the Trans-Pacific Partnership agreement, has one entire chapter devoted to SOE issues, not necessarily about China but, you know, probably having Chinese SOEs in mind.

But in my view, those special laws and policies that target Chinese SOEs suffer the problem of being both overinclusive and underinclusive. They're overinclusive because they presume all SOEs to be, to have close enough ties with the government to warrant special scrutiny. They are underinclusive because they leave out firms that are privately owned but nonetheless are subject to extensive control by the government.

As I just said, you know, the Chinese government exerts much lesser degree of control over SOEs than its ownership interest in the SOEs suggests. But the flip side of the same coin is that the Chinese government exerts much more control over private firms than its lack of ownership interest suggests because the Chinese government controls vital resources in the economy, and those vital resources are doled out to firms in a process that is not subject to effective disciplines of the rule of law. All firms in China, both SOEs and private firms, have incentives to cater to the government's priorities.

And in addition, the Chinese government has not always scrupulously respected the property rights, the private property rights that accompany private property. It doesn't have to have explicit ownership stakes in the firms to exercise control. So the Chinese government can have a lot of control over private firms through many mechanisms. For example, informal price controls, quasi-governmental organizations, and extra-legal governmental fiats.

So because of this institutional environment, the boundary between SOEs and the private firms in China is really blurred. So all of the SOEs and maybe most of the large private firms, they share substantial similarities in many areas that are commonly thought to distinguish SOEs from private firms, including market access, proximity to state power, receipt of state subsidies, and execution of government objectives.

So, in my view, the hallmark of Chinese state capitalism is not SOEs. The hallmark of Chinese state capitalism is an ecosystem in which the government is at the center of the economy and everybody else caters to the government's needs.

So with that, I conclude my testimony and will be happy to answer questions.

HEARING CO-CHAIR CLEVELAND: Thank you very much, Dr. Zheng. Very interesting.

PREPARED STATEMENT OF DR. WENTONG ZHENG
ASSOCIATE PROFESSOR OF LAW, UNIVERSITY OF FLORIDA LEVIN SCHOOL

Prepared Statement of
Wentong Zheng
Associate Professor
University of Florida Levin College of Law

Testimony before the U.S.-China Economic and Security Review Commission
Hearing on China's Shifting Economic Realities and Implications for the United States

February 24, 2016

Thank you Chairman Shea, members of the Commission, and staff. I appreciate the opportunity to share my views about state-owned enterprises ("SOEs") in China and their implications for the United States. My testimony today addresses four distinctive issues: 1) the role of SOEs in the Chinese economy; 2) the nature of state control of SOEs; 3) China's "Going-Out" policy and SOEs; and 4) U.S. laws and policies on Chinese SOEs.

I. The Role of SOEs in the Chinese Economy

SOEs in China have undergone significant changes since China embarked on economic reforms in the late 1970s. Prior to economic reforms, SOEs were the default arrangement in almost every industry. In the subsequent four decades that followed, China's SOEs were commercialized, corporatized, and in many cases, privatized. Today, China boasts an emerging private sector that has become a major driver of economic growth, employment, and exports.[1]

That said, the state still plays a very important role in China's economy. Official statistics indicates that as of 2011, wholly state-owned enterprises, along with state-holding enterprises in which the state holds the largest percentage of shares among all shareholders, accounted for 26.2% of gross industrial output, 41.7% of total industrial assets, and 19.8% of employment.[2] If the definition of the state sector is broadened to include all enterprises in which the state holds some ownership stakes, then the role of the state in the economy is even greater. By one estimate, these so-called mixed-ownership enterprises alone account for 40% of China's GDP.[3]

While SOEs maintain a strong presence in China's overall economy, they tend to be concentrated among the largest firms in key industries. In 2009, 331 of China's largest 500 firms by revenues were SOEs.[4] Almost all of China's most important industries, including national defense, electricity, petroleum and petrochemicals, telecommunications, coal, civil aviation, waterway

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[1] *See* NICHOLAS LARDY, MARKETS OVER MAO: THE RISE OF PRIVATE BUSINESS IN CHINA 59-122 (2014).
[2] Fan Gang & Nicholas C. Hope, *The Role of State-Owned Enterprises in the Chinese Economy*, at 7, http://www.chinausfocus.com/2022/wp-content/uploads/Part+02-Chapter+16.pdf (citing *China Statistical Yearbook* data).
[3] *See Mixed-Ownership Sector Accounts for 40% of Economy, To Hit 80% in 5-10 Years*, XINHUA, November 25, 2003, http://www.southcn.com/news/china/zgkx/200311250786.htm.
[4] *See* Wentong Zheng, *Transplanting Antitrust in China: Economic Transition, Market Structure, and State Control*, 32 U. PA. J. INT'L L. 643, 665 n.99 (2010).

transportation, banking, and insurance, are dominated by SOEs. In 2015, of the 98 Chinese companies that made their way to the Fortune Global 500 list, the top 12 were all SOEs and only 22 were purely private firms.[5]

The scale and importance of China's SOEs exceed those of the SOEs in other advanced economies. According to a recent OECD study, in 27 of the 34 OECD member countries, employment in SOEs exceeds 6 million people and the value of all SOEs combined is close to US$2 trillion.[6] On average, SOEs in those countries account for 15% of GDP.[7] The composition of SOEs in OECD countries is heavily skewed towards public service sectors like utilities, specialized financing entities, and transportation.[8]

II. State Control of SOEs

Decades of economic reforms have transformed the nature of the Chinese government's control of SOEs. SOEs in China today are no longer the alter ego of the state; instead, they are, like private firms, managed by human agents responding to market incentives and institutional constraints.

One of the hallmarks of China's economic reforms is the delegation of decision-making authority over pricing and other business matters to SOEs. These so-called "commercialization" reforms have largely kept the government out of the day-to-day management of SOEs. As in other former communist countries, such reforms in China have turned SOE managers into de facto controllers of SOEs and resulted in what becomes known in the economic literature as the "insider control" problem.[9]

The Chinese government does retain some important control over SOEs. The State-Owned Assets Supervision and Administration Commission ("SASAC"), a cabinet-level agency established in 2003, supervises 107 or so large SOE groups on behalf of the central government. SASAC exercises the government's rights as a controlling shareholder as well as regulatory power over SOEs. In particular, SASAC has occasionally reshuffled top managers among SOEs. The latest reshuffling took place in August 2015 in the telecommunications industry, where the chairmen of the three largest telecommunications companies in China, all SOEs, swapped positions.[10] Such reshuffling indicates tight state control over high-level personnel appointments at SOEs. Indeed, as scholars have noted, SOEs in China are deeply enmeshed in a larger system of party-state organs, fostered through rotations of managers, personnel exchanges, and the wearing of different hats by managerial elites.[11]

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[5] Scott Cendrowski, *China's Global 500 Companies Are Bigger Than Ever—And Mostly State-Owned*, FORTUNE (Jul. 22, 2015), http://fortune.com/2015/07/22/china-global-500-government-owned/.
[6] HANS CHRISTIANSEN, THE SIZE AND COMPOSITION OF THE SOE SECTOR IN OECD COUNTRIES 3 (2011).
[7] *Id.* at 17.
[8] *Id.* at 14-15.
[9] *See* Masahiko Aoki, *Controlling Insider Control: Issues of Corporate Governance in Transition Economies*, in CORPORATE GOVERNANCE IN TRANSITIONAL ECONOMIES: INSIDER CONTROL AND THE ROLE OF BANKS 3, 7–12 (Masahiko Aoki & Hyung-Ki Kim eds., 1995).
[10] *See* Charles Clover, *Leadership Reshuffle at China's Three Biggest Telecoms Groups*, FINANCIAL TIMES (Aug. 24, 2015), http://www.ft.com/intl/cms/s/0/09b7296e-4a44-11e5-9b5d-89a026fda5c9.html#axzz40XpuTpnj.
[11] *See* Li-Wen Lin & Curtis J. Milhaupt, *We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China*, 65 STAN. L. REV. 697, 708 (2013).

Besides personnel control over SOEs, the Chinese government still retains price control over certain products or services, such as gasolines, natural gas, and pharmaceuticals, although the number of such products and services has been dramatically reduced. In addition, the Chinese government maintains informal price control over potentially all products and services through exerting pressures on firms, even though such pressures have no apparent legal basis.[12] These formal or informal price controls, however, are not specific to SOEs and apply to firms of all ownership types.

Despite the above-discussed mechanisms of control, state control over SOEs is not perfect. The human agents managing SOEs, like everybody else, attempt to maximize financial or political payoffs for themselves. This means that SOEs have incentives to foster close ties with party-state organs, seek government largesse, and resist government policies that are not in their best interests. The bureaucrats that are supposed to oversee SOEs are agents of the state themselves. Without effective monitoring by the public, there is no guarantee that these bureaucrats will be able to implement policies that are in the best interests of the state.

As a result of this agency problem, the Chinese government controls SOEs to a much lesser degree than its ownership interest in the SOEs suggests. The lack of effective state control is reflected in several patterns observed in the SOE sector. First, the government collects little or no dividends from SOEs. Chinese SOEs pay a dividend rate of only 5 to 15 percent to the state, far below the 50-60 percent dividend rates paid by established industrial firms in the United States.[13] Second, SOE executives enjoy wide discretion in receiving large amounts of compensation in the forms of private benefits and on-duty consumption, despite the government's repeated efforts to reign in SOE executive compensation. Third, the government often fails to implement major policy or operational decisions at SOEs, as seen from the government's failure to have SOEs withdraw from the real-estate sector when housing prices were skyrocketing several years ago. These patterns could be interpreted as government favoritism for SOEs, but they are also consistent with SOEs "capturing" the state and putting state power at their service.

III. China's "Going Out" Policy and SOEs

Since the turn of the century, the Chinese government has promoted a "going out" policy and encouraged Chinese firms to invest in overseas markets. Not coincidentally, foreign direct investment ("FDI") by Chinese firms in the United States and other major markets has experienced exponential growth. According to one estimate, in 2009-2010, China's FDI assets in the United States increased by 130%.[14] The total inflow of Chinese FDI into the United States reached $5.3 billion in 2010, bringing the total amount of Chinese FDI in the United States since 2003 to $11.6 billion.[15]

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[12] For detailed discussions of such extra-legal price control, see Curtis J. Milhaupt & Wentong Zheng, *Beyond Ownership: State Capitalism and the Chinese Firm*, 103 GEO. L.J. 665, 687 (2015).
[13] *See* World Bank, *Effective Discipline with Adequate Autonomy: The Direction for Further Reform of China's SOE Dividend Policy* 13, 23-30 (2010), World Bank Policy Note No. 53254.
[14] *See* Charles W. Freeman III and Wen Jin Yuan, *China's Investment in the United States: National Initiatives, Corporate Goals, and Public Opinion*, Center for Strategic & International Studies (Nov. 2011), at 1.
[15] *Id.*

The composition of Chinese FDI in overseas markets has evolved over time. The focus of Chinese FDI was initially on energy and natural resources, then shifted to the service sector, and more recently switched to the acquisition of advanced technologies and customers in developed markets.[16]

SOEs play an important role in China's outward direct investment. According to Chinese government data, SOEs accounted for 70% of China's global FDI stock as of 2009, reflecting the advantages SOEs had in obtaining government approvals for FDI in the early years of the going-out policy.[17] SOEs in the oil and gas sector have been particularly active in outward FDI. In more recent years, however, private firms have begun to play catch-up with SOEs. Between 2003 and 2010, 170 of 230 recorded FDI transactions made by Chinese firms in the United States were made by private firms, defined as having 80% or higher non-governmental ownership.[18]

While SOEs account for a large percentage of China's outward FDI, few of them make FDI decisions based solely on political considerations. Due to the commercial orientation of most of the SOEs, and also due to the lack of effective state control over SOEs, most SOEs invest in overseas markets only if there are sufficient commercial justifications. SOEs may gain from FDI projects either through the projects themselves—if the projects are profitable—or through advantages they may obtain from the Chinese government in the home market for catering to the government's priorities. In short, when it comes to outward FDI, Chinese SOEs should no longer be presumed to be pursuing the political goals of the Chinese government.

IV. U.S. Laws and Policies on Chinese SOEs

Current U.S. laws and policies possess many tools to address the nonmarket behaviors of Chinese SOEs. Upon China's accession to the World Trade Organization in 2001, the United States successfully negotiated special requirements regarding subsidies to Chinese SOEs.[19] U.S. antidumping and countervailing duty laws allow U.S. manufacturers to petition the U.S. government to impose special duties on Chinese imports to address unfair trade practices by Chinese SOEs as well as private firms.[20] The foreign investment approval process in the United States equips the U.S. government with the power to block investment by Chinese SOEs that may pose national securities concerns. Finally, some of the ongoing trade initiatives of the United States, such as the U.S.-China Bilateral Investment Treaty and the Trans-Pacific Partnership ("TPP"), contain special provisions on the nonmarket behaviors of SOEs. In particular, the treaty text of the TPP includes one entire chapter devoted to SOE-related issues.[21]

Current U.S. laws and policies on Chinese SOEs, however, suffer the problem of being both overinclusive and underinclusive. They are overinclusive because they presume *all* Chinese SOEs to have sufficiently close ties with the Chinese government to warrant special scrutiny. They are

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[16] *See* Daniel Rosen and Thilo Hanemann, *An American Open Door? -- Maximizing the Benefits of Chinese Foreign Direct Investment,* Asia Society (May 2011), at 20, http://asiasociety.org/files/pdf/AnAmericanOpenDoor_FINAL.pdf.
[17] *Id.* at 33.
[18] *Id.*
[19] *See* Accession of the People's Republic of China, WT/L432 (Nov. 23, 2001), art. 10.
[20] *See* 19 U.S.C. §§ 1671-1677n (2015).
[21] *See* The Trans-Pacific Partnership Agreement, Chapter 17, https://medium.com/the-trans-pacific-partnership/state-owned-enterprises-and-designated-monopolies-bfddb20cb3b3#.c48idp81n.

underinclusive because they leave out firms that are privately owned but are nonetheless subject to extensive control by the Chinese government. As discussed above, because of agency costs, the Chinese government exercises much less control over SOEs than its ownership interest in the SOEs suggests. But at the same time, the Chinese government exercises much more control over private firms than its ownership interest (or the lack thereof) in the private firms suggests. Because the Chinese government does not scrupulously respect the legal rights that accompany private property, it does not need explicit ownership stakes to exercise control over firms. The government could, and indeed does, exercise extensive control over private firms through informal price control, quasi-governmental organizations such as industrial associations, and extra-legal governmental fiats.[22]

This institutional environment results in blurred boundaries between SOEs and private firms in China. SOEs and large private firms in China share many similarities in areas commonly thought to distinguish state-owned firms from privately owned firms: market access, receipt of state subsidies, proximity to state power, and execution of the government's policy objectives. In light of this institutional environment, U.S. laws and policies that single out Chinese SOEs on the basis of government ownership alone are inherently misleading.

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[22] For detailed discussions of state control of private firms in China, see Milhaupt & Zheng, *supra* note 12, at 683-88.

OPENING STATEMENT OF DR. ROSELYN HSUEH
ASSISTANT PROFESSOR OF POLITICAL SCIENCE AND ASIAN STUDIES, TEMPLE UNIVERSITY

DR. HSUEH: Great. Thank you, Commissioners, for inviting me back to testify. So today in my capacity as a political scientist, I'm going to talk about the political logic of Chinese-style capitalism, and I'm going to make the argument that despite recent political developments, we essentially see the same modus operandi that the Chinese government is operating in China since the reform era and also particularly since 1992 when Deng Xiaoping reopened the Chinese economy after Tiananmen.

So in the past few decades of China's "reform and opening," the conventional wisdom is that the institutional foundations of Chinese-style capitalism has been affected by liberal reformers, China's participation in international organizations, devolution of economic decision-making, local experimentation, and the proliferation of market actors.

And, in fact, the Chinese economy, in many senses, is quite open and very openly competitive. Most recently, the prevailing perspective is that the underlying logic is changing. And the underlying logic is changing because of antitrust actions, intellectual property enforcement in favor of Chinese indigenous industry, and, also, of course, Xi Jinping's anti-corruption campaign.

Other explicit state interventions include the devolution of devaluation of the Chinese currency and sweeping measures to prop up the country's stock market. In fact, in 2013, at the Chinese Communist Party's Third Plenum of the 18th National Congress, China, on one hand, reaffirmed the "opening up" and promised "comprehensively deepening reforms," but at the same time emphasized the importance of national security, internal and external security, social and economic consequences of reform, innovation and global competitiveness of Chinese industry. These were all identified as critical issues.

So it appeared there's some contradiction. On one hand, very market oriented, but on the other hand, the political logic, the goals of the state continues to dominate.

And my argument is that actually this combination of both market practices and deliberate state intervention has held and continues to hold and will continue to hold as we move forward.

And let me tell you a little bit about Chinese-style capitalism. It incorporates two major components. First is market coordination, which combines competition with deliberate regulation to achieve industrial modernization and economic and security goals. So we have on one hand, market coordination, which combines competition and deliberate regulation, and then we have, on the other hand, where the Communist Party ensures that the industries it sees as particularly valuable, especially in external and internal security, technology, and overall competitiveness of the economy, are owned primarily by Chinese businesses, whether state owned or private. And that's actually quite important.

Now, I agree with Dr. Zheng that state-owned enterprises are not made equal. Private enterprises are also not made equal in China. And there's a political logic, and that logic is a strategic value logic. Well, how do we define strategic value? I think that becomes the ultimate question.

I make the argument that the perceived strategic value of a sector is defined politically and economically, and it drives leaders to intentionally combine the use of markets and calibrated state intervention. The external and internal security, technology, overall economic competitiveness, these are all goals very important to the state.

And how does that actually then pan out in the economy? What we find is that in industries perceived to be less strategic for application for national security, the national technology base, and the competitiveness of other sectors, we have the decentralized market stakeholder pattern. In a decentralized market stakeholder pattern of state market interactions, we have decentralized authorities, including local governments, sector and business associations, acting as economic stakeholders, as opposed to dominant owners and managers in a fiercely competitive environment.

The business and politics of markets are local, and companies have to contend with the vagaries of local politics, which is why in the third, you know, in the second, third, fourth tier markets, oftentimes American companies grapple not so much with the central government but much more so with local stakeholders, and those local stakeholders are not just government stakeholders. They are sector and business associations, maybe ten or 20 years ago or at some point the economic bureau, but are no longer part of the state. Yet they remain local stakeholders with economic decision holding capacity and capability and sometimes lack of capability and capacity.

And so having to deal with the vagaries of local politics, regulatory arbitrariness, and lack of central will and regulatory capacity in enforcing macroeconomic-wide rules, we see overexpansion, overcapacity, price cutting strategies become the norm.

In contrast, in industries perceived to be strategic to the state, those with significant application for national security, contribution to the national technology base, and the competitiveness of other sectors in the economy, what we find is that 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, business scope and competition between market players.

This doesn't mean that the state in these strategic sectors necessarily own the assets. They could be only state backed market stakeholders or state shareholders, and oftentimes the state does own assets, but they don't have to own assets. And so state-owned enterprises and private and foreign companies coexist, but the state remains dominant in managing and/ or setting the standards for the adoption of foreign technology and the initiation and implementation of indigenous technology.

And so this dominant pattern of market coordination and distribution of property rights we see manifesting in industries such as telecommunications, banking, energy sectors and automobiles. And of course, there's going to be variation in some of these market governance roles which vary by subsector and time, but there's a strategic value logic to how it varies by subsector as well.

My take is that the anti-corruption campaign since 2013 has intensified market guidance and supervision of SOE executives, but the practice of rotating, playing musical chairs, of executives actually go way back to the 1980s, to the 1990s and on to today. That practice is not going to change, but the psychological and intensification of Party guidance is certainly there and may intensify.

I also see that the 26 SOEs targeted by the Central Committee of Discipline Inspection for investigation across a range of industries and actually have also spilled over to the private sector. And so in that sense, the corruption campaign has touched the entire economy, but I do not feel that the campaign and some of these political developments will alter the reality of the Party-state deliberately and actively engaging in market coordination and asset shareholding according to the strategic value logic that I have identified.

The 13th Five Year Plan--let me just speak quickly about that--again seeks to modernize infrastructure, guarantee national security, ensure social and political stability. It aims to boost economic growth during a slowed period of growth, and it aims to sustain China's increasing per capita income, moving China--at least have the aspiration of moving China into the middle-income economy. But the industries targeted, again, fit the strategic value logic that I talk about.

We're going to see support for industrial upgrading and indigenous innovation in agriculture, emerging industries, renewable energy, civil-military integration, emphasis on service sectors, health care, information communications technology.

Deliberate regulation will be on market entry, business scope, investment, perhaps ownership, but perhaps not, capital markets and standards setting. Likewise, the new "Guiding Opinions of the Central Committee of the Communist Party on the Deepening of State-Owned Enterprise Reform," which was released in September of last year, reiterates the Party's central role in internal supervision of SOEs and actually, in fact, acknowledges this dual role of market coordination and ownership, and it differentiates SOEs that operate on market logic and SOEs that operate on political logic, reflecting the strategic value logic that I'm talking about.

And obviously Chinese-style capitalism and strategic value logic will have impact with global implications now that Chinese industry has come of age and they are now spreading into the outside world outside of China, and we will see that the Chinese government, along with financial and legal institutions, will work with Chinese state-owned enterprises and state-backed privately owned enterprises to tap into these market opportunities.

Thank you.

PREPARED STATEMENT OF DR. ROSELYN HSUEH ASSISTANT PROFESSOR OF POLITICAL SCIENCE AND ASIAN STUDIES, TEMPLE UNIVERSITY

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Roselyn Hsueh, Department of Political Science, Temple University

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

Chinese-style Capitalism and Implications of Recent Developments

In the past few decades of China's "reform and opening," conventional wisdom on the institutional foundations of Chinese-style capitalism underscores the impact of liberal reformers and China's participation in international organizations, devolution of economic decision-making and local experimentation, and the proliferation of market actors to explain their origins. More recently, prevailing perspectives of China watchers and political pundits alike contend that the underlying logic of Chinese-style capitalism has transformed in light of anti-trust actions and intellectual property enforcement in favor of Chinese industry and Chinese president Xi Jinping's anti-corruption campaign to consolidate Xi's political power and safeguard the legitimacy of the Chinese Communist Party (CCP). Other explicit state interventions include the devaluation of Chinese currency and sweeping measures to prop up the country's stock market, the ups and downs of which have reverberated globally. The Third Plenum of the 18th National Congress of the Chinese Communist Party in 2013 affirmed China's "opening up" and promised "comprehensively deepening reforms" at the same time identified national security, with emphasis on internal security; social and environmental consequences of reform; and innovation and global competitiveness of state-owned industries as critical issues confronting the country.

These seemingly contradictory practices reflect the *modus operandi* in the last several decades of China's globalization and do not significantly alter the underlying political logic of Chinese-style capitalism. Government actions in both unleashing market forces and protecting state interests date back to Deng Xiaoping's reopening of the country to foreign investment in 1992. Beginning in the early 1990s, after initial market liberalization, Chinese companies started collaborating with foreign partners. Once they benefited from technology and knowledge transfers, however, the government has time and time again restricted the ownership structure and business scope of foreign direct investment (FDI) and intervened to promote indigenous technology, incubate Chinese business in fledging industrial sectors, and ensure their long-term market foothold. My recent *Governance* article ("State Capitalism, Chinese-Style: Strategic Value of Sectors, Sectoral Characteristics, and Globalization") shows that Chinese-style capitalism involves two primary components. First is market coordination, which combines competition with deliberate regulation to achieve industrial modernization and economic and security goals. Second, the CCP works to ensure that industries it sees as particularly valuable—especially in external and internal security, technology, or for overall economic competitiveness—are owned primarily by Chinese businesses, whether state-owned or private.

During a protracted period of political consolidation by Xi and his supporters, the political dimension of market governance is more somberly and intensely experienced. The Third Plenum announced the establishment of the National Security Commission, a rule of law plan, and a leading group to strengthen market forces to achieve stated goals. Moreover, Xi usurped the power of the premiership by creating under his oversight small leading groups, which are not new in the management of markets in strategic industries, when they were traditionally within the premier's portfolio. All the same, state and market combinations of economic governance, which vary by sector, have not changed significantly. Barring pointed failure of Xi's anti-corruption campaign, it remains business as usual in deliberate Chinese state actions toward markets according to a strategic value logic.

The Strategic Value Logic of China's Sectoral Patterns of Market Governance

The institutional foundations of the macro Chinese economy do not have a unitary character. The Chinese state deliberately combines liberal economic and state interventionist mechanisms in sector-specific ways. Sectoral variation in market governance in Chinese-style capitalism reflects first and foremost the Chinese state's priorities and how they are constructed. The *perceived strategic value of a sector*, defined politically and economically, drives state leaders to deliberately combine the use of markets with calibrated state intervention. Beyond that, sectoral structures and economic conditions and existing institutional arrangements influence details within dominant patterns of institutional development.

In industries perceived by the state to possess low strategic value for application for national security, contribution to the national technology base, and the competitiveness of other sectors in the economy, the *decentralized market stakeholder* pattern of devolved market coordination and predominance of quasi-state and private ownership holds. For example, China introduced competition in *textiles* in the 1980s and devolved market coordination to local governments and commerce bureaus by the early 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 aggressively. 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*.

In contrast, in industries perceived to be strategic to the state, those with significant application for national security, contribution to the national technology base, and the competitiveness of other sectors in the economy, 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 coordination and distribution of property rights manifests in strategic industries from *telecommunications* and *banking* to *energy sectors* and *automobiles*.

The *centralized government shareholder* pattern of market governance in *telecommunications*, an industry of high importance to national security and high contribution to the national technology base and the competitiveness of the rest of the economy, enables the Chinese state to achieve its security and developmental goals even while introducing competition and exposing the industry to global economic integration. The actual market governance details vary by subsector and time, in cycles of liberalization cum reregulation, as I delineated in my 2011 book *China's Regulatory State: A New Strategy for Globalization*. Beijing broke up the country's telecommunications monopoly in 1994 and allowed foreign telecommunications service providers and equipment makers to invest in joint ventures and sell in the domestic market, exposing Chinese industry to foreign expertise and knowhow. Later in the decade, foreign investors, including Sprint, Motorola, Deutsche Telekom and France Telecom, teamed with newly formed state-owned telecommunications carriers to build new generation communications networks. Fearful of relinquishing control of the communications infrastructure and during state entrenchment in response to the economic reverberations of the East Asian financial crisis of the late 1990s, the government forced the divestment of FDI, restructured the state-owned operators, and merged the then- separate telecommunications equipment and service ministries.

China became a member of the World Trade Organization in 2001, making a series of liberalizing commitments in its accession protocol. Yet today, 15 years later, the government owns basic telecommunications services and only permits competition in value-added services (VAS) among domestic companies, such as Alibaba, whose initial public offering (IPO) in the New York Stock Exchange in fall 2014 received more investment than did Facebook, Google, and all previous Internet IPOs. In the fiercely competitive VAS markets, the leaders are Alibaba and other domestic companies with ownership structures and corporate governance connected to Chinese elites. In 2010, China forced Yahoo to divest itself of Alipay, Alibaba's e-payment subsidiary, in which it had invested as a major investor. As I documented in *Review of Policy Research* ("Nations or Sectors in the Age of Globalization: China's Policy Toward Foreign Direct Investment in Telecommunications"), this represents China's open-door-close-door approach toward foreign investment, allowing Chinese companies to take advantage of foreign investment to upgrade Internet services, and then constraining the market scope of FDI.

Today Yahoo, Google, and other foreign companies are limited to minority shares in service segments, like online advertising, that are less important to security and less financially lucrative. Moreover, all telecommunications service providers are expected to follow censorship laws and self-police their content, and to operate on the networks owned and managed by the government. These methods allow the government to consolidate its control over the business of the Internet, including profits and the dissemination of information, to enhance the national technology base, maintain political stability and ensure national security. The new national security law and proposed laws on cybersecurity and counterterrorism fall along the same lines.

Inviting and then restricting the ownership structure and business scope of foreign investment is half of the use of markets. China also takes a more aggressive role in governing the market in a way that gives Chinese-owned companies an advantage and ensures the country's hold on critical technologies. In telecommunications equipment, the government postponed the licensing of foreign technologies for nearly a decade when technical difficulties delayed the release of China's homegrown third-generation networking standard. It then restructured the state-owned carriers to ensure the smooth implementation of TD-SCDMA, the research and development of which involved collaboration between Chinese state-owned companies and foreign ones. The competitive state-owned operators vacillate between competing fiercely with price-cutting strategies and working together to share network infrastructure and technology, in line with the strategic orientation of state coordination of market developments in response to goals of technological development and national security and structural sectoral and economic conditions.

The *centralized government shareholder* pattern of market governance holds in other industries, which score high on the economic and political measures of strategic value. For example, to maintain central control of the national money supply, exchange rate, and other macroeconomic tools, the state centralizes supervision of financial services along subsector lines due to competing bureaucratic interests; retains ownership and management of the Big Four banks; and restricts FDI to minority foreign equity investment. Moreover, parallel to the less restrictive regulation of telecommunications VAS, the state permits private and foreign market entry in select subsectors of financial services, using public-private joint venture arrangements to develop indigenous capacity and retain supervision of financial and human resources. In the last couple of years, Beijing has brought anti-trust actions against foreign automakers and auto parts manufacturers, including Daimler and Volkswagen, and high technology companies, such as Qualcomm and Microsoft, accusing them of overcharging, price manipulation and abusing their market position. Legal decisions ruled in favor of Chinese companies in intellectual property disputes, such as the case involving American company Vringo and ZTE, a Chinese state-owned telecommunications equipment maker, further reveal how China governs markets to enhance the national technology base.

Chinese-style Capitalism Going Forward

The anti-corruption campaign since 2013 has intensified party guidance and supervision of SOE executives and increased inspection and auditing of SOEs. The 26 SOEs targeted by the Central Committee of Discipline Inspection for investigation are from a range of industries, including, construction, electricity, finance, mining, nuclear, petroleum, steel, telecommunications, and transportation. Private entrepreneurs have also been taken custody. These developments do not alter the reality of the party-state deliberately and actively engaging in market coordination and asset shareholding according to a strategic value logic.

The 13th Five-Year Plan, approved in late 2015, also does not change the direction of Chinese-style capitalism. The plan seeks to modernize infrastructure, guarantee national security, and ensure social and political stability. It aims to boost economic growth during a period of slowed growth and sustain China's increasing per capita income. This will be achieved through competition and deliberate regulation (of market entry, business scope, investment, ownership, capital markets, and standards setting), employing new and time tried methods, to support industrial upgrading and indigenous innovation in agriculture and emerging industries, such as those in renewable energy and civil-military integration, and including service sectors, such as healthcare and information communications technology. Likewise, the "Guiding Opinions of the Central Committee of the Communist Party of China and the State Council on Deepening State-

Owned Enterprise Reform" released in mid-2015 reiterates the party's central role in the internal supervision of SOEs, acknowledges the state's dual role in market coordination and ownership, differentiates between "public" vs. "commercial" SOEs, which operate on political vs. market logics, respectively, and underscores the state's controlling interest in strategic sectors even as private shareholding is permitted.

PANEL II QUESTION AND ANSWER

HEARING CO-CHAIR CLEVELAND: Wow. Where to begin? Commissioner Bartholomew.

VICE CHAIRMAN BARTHOLOMEW: Oh, boy, beginning with me. Thank you to all of our witnesses.

This was really interesting, and I'm pleased, Dr. Hsueh, that you at least mentioned the Party because just as in the first panel, we managed to have a discussion about the Chinese economy without really acknowledging the fact until the end that it's a state-controlled economy, it's interesting to me that we haven't talked that much about the role of the Party.

So Dr. Zheng, I'd like to actually ask you first, but I'd like the others to weigh in. I think it's important for Americans to understand that Chinese private companies are not what we understand as private companies, can you dig into that?

You talked a little bit about the government control, but in terms of the role of the Party, can you talk a little bit about the Party and its representation? Is the Party ideology being represented on boards of private companies? Are workers being required to engage in certain Party building exercises?

You know, as Xi Jinping is cracking down on media and cracking down on journalists, I just wondered how this was playing out in the, quote-unquote, "private sector" in China?

DR. ZHENG: Sure. I'll be happy to talk about the role of the Party in the Chinese economy. The Party doesn't even have a rule that says all firms have to have Party committees. It's a common misconception that China has such a rule. The Party only has its platform, only has a requirement that if one organization has more than a certain number of Party members, then you have to form a committee. But there's no formal requirement that any firms, including SOEs, have to have Party committees.

So, but that said, many private firms choose to have Party committees for all sorts of reasons. If I'm not mistaken, I think even some of the foreign-invested firms like Walmart. I could be wrong on this. You know, they have Party committees. That's not a decision forced by the Party or the state. It's more of a voluntary decision.

Now, many researchers have been asking the question why do they have Party committees? My personal take of this is, you know, this indicates the willingness to cooperate with the state, with the Party, and that willingness to cooperate with the state is so important in the Chinese economy.

As I just mentioned in my testimony, the state controls so many vital resources, you know, like low-cost financing, regulatory resources. You have to have the help of the state in order to prosper or even survive. So indicating your cooperation with the Party, with the state, is one way to survive in the Chinese economy. So again my personal take on this is it's more about self-cooperation. It's less about direction or coercion from the Party.

VICE CHAIRMAN BARTHOLOMEW: Right. You know what's good for you and so you do it.

DR. ZHENG: Exactly.

VICE CHAIRMAN BARTHOLOMEW: That's--

DR. ZHENG: Yes.

VICE CHAIRMAN BARTHOLOMEW: But is the government, and obviously the government and the Party are synonymous, but does it have the ability to place people on boards or to ensure that members of the board of private companies in China have fealty?

DR. ZHENG: I cannot talk about the specific companies, but I can say something in general. The government really has the power to do almost everything, and that includes the power to appoint board of directors of private companies, even if the government doesn't have the explicit ownership stakes in the private firms. But in many situations, what's going on, you know, is not in the open.

You can't really tell, you know, why somebody is on the board of a company. That could be because of connections with a state-owned bank that it provides major financing to the company. That could be because of personal connections with high-level government officials. You know we don't really know.

But what I want to emphasize is that China's institutional environment is not like the one that we see in the United States or in any other major Western countries. China's institutional environment is one in which the state doesn't really face a lot of rule of law constraints so a lot of things that are happening in China are really under the scene so I don't really know what's happening with specific firms, but my personal view is, yes, China does have the power or the Party does have the power to appoint directors.

VICE CHAIRMAN BARTHOLOMEW: And I'll ask our other witnesses, but let me add one more question into the mix, and that is do Chinese shareholders in these private companies have the ability or the right for annual elections for board members?

DR. ZHENG: Yes, they do. The short answer is, but again, you know, like anything else in China, those mechanisms on the book may not be what they actually mean in practice.

VICE CHAIRMAN BARTHOLOMEW: Okay. Thanks.

Dr. Hsueh.

DR. HSUEH: I would just add a couple points. I think we cannot overemphasize the informal dimension of state-market interactions in China, and so the question of how penetrated is the Party in private enterprises is one, of course, it's going to vary by firm and vary, to some extent, by sector, as well.

But I do have to say that, yeah, a lot of firms we know even without the formal rules to form Party cells oftentimes do, and there are also many other ways of catering and interacting with the Party, by joining the local Party Congress, by joining particular sector and business associations, and this is in, even in the deregulated sectors. A lot of former government officials now are, they work for these sector associations, and interacting with them, and being seen in political activities or even just social activities is always a good thing.

Another point I wanted to make is that the Party's control isn't necessarily ideological. In fact, some of the goals I mentioned are rational instrumental, right? Competitiveness of the national economy, political and social stability, application for the national technological base, these are pretty instrumental rational goals. So the Party's attempt to manage the economy isn't just ideological, and, in fact, I think we've left ideology behind several, several decades ago.

VICE CHAIRMAN BARTHOLOMEW: Maybe, but--

DR. HSUEH: Yes.

VICE CHAIRMAN BARTHOLOMEW: But the goal of the Party is to retain its hold on power.

DR. HSUEH: Oh, for sure. Party legitimacy is critical.

VICE CHAIRMAN BARTHOLOMEW: So Party legitimacy--

DR. HSUEH: Yes.

VICE CHAIRMAN BARTHOLOMEW: --underlies even the rational goals that you're talking about or I think overlays the rational goals.

Mr. Hubbard, anything to add?

MR. HUBBARD: Yes, thank you.

I'd reiterate the same point that I think the other panelists have made, that you wouldn't want to have a lot of money invested in China and not be on good terms with the government. Just in relation to the mechanics of it, there is a slightly different role for Party organizations in private companies versus SOEs.

The company law--and China is not embarrassed about this--the company law itself provides for the creation of Party cells in private companies where their role there is, on paper at least, is meant to be advisory, whereas, in SOEs, the Party role is actually to have, if you like, a formal veto right over made decisions. So it goes further in SOEs than in the private firms.

Just one thing, though, on the idea of the Party, I think even though the SOE reforms that we talked about from last year are designed to simultaneously reduce the interference of the state at a bureaucratic level but reinstitute or strengthen Party leadership, I'm not sure that the Party has the same interest in bureaucratic micromanagement as the state apparatus might. I think the goal of the Party is to make sure that the person in charge is sound from a Party perspective but not to manage the firm in the same way that the state bureau may have wanted to manage the firms in the past.

Just one other thing, with big SOEs, the top of that SOE will be integrated into a career structure that involves the government or involves other things, and that's decided by the Party. In the private sector, you might be a Party member perhaps, but your future isn't tied to the Organization Department in the same way that it might be in SOEs. So you might be joining the Party in order to protect your business rather than the other way around.

VICE CHAIRMAN BARTHOLOMEW: Right. Okay. Thank you. Thanks, Madam Chair, for your generosity with the time.

HEARING CO-CHAIR CLEVELAND: Commissioner Wessel.

HEARING CO-CHAIR WESSEL: Thank you.

This has been a great panel, and Dr. Zheng, I think your definition of the ecosystem is probably one of the better definitions that I've heard, and we've been working for years to try and define things. But it's sort of an amoebic approach, that it's hard to define, and it's not a word-based definition. It is a facts-and- circumstances situation.

And it's hard for me to understand the political concern in China right now about the use, for example, of our CFIUS statute and the view that we are being unfair as we look at certain transactions. When I hear the two latter participants talking about sort of this is again something you have to see, feel, and understand, that it is not whether you're SOE or private; it's really the question of what is the state's interest in the transaction?

And, you know, any outward bound transaction over $1 billion, requires not only filing by that Chinese entity but a review. They've changed the language, that it's not approval but review, and presumably an entity that wants to make a major outward bound investment won't do it or won't be able to do it if the government doesn't agree.

So, again, I think we have to go back to facts and circumstances and worry a little less whether it's SOE, SIE, you know, TVA, you know, any of the various definitions.

And Mr. Hubbard, that brings me to a question for you. There was a question.

VICE CHAIRMAN BARTHOLOMEW: We wondered.

HEARING CO-CHAIR WESSEL: Your initial comments to me seemed to be somewhat rigid, if you will, and an economic test. You know, the SOEs have this percentage of the economy. But Australia has probably one of the broadest investment review regimes in the world, with the net economic benefit test that your country operates, which is again beyond our CFIUS national security standard.

And during the recent TPP discussions, both Australia and Canada fought to retain their net economic benefit domestic statutes. As a former Treasury official, can you help me understand, without going into a specific transaction, you were talking about SOEs and their activities, when the country looks at an inward bound investment, a Chinese one, how rigorous is the review?

Are you looking at it--and I understand that you got resources, you have a lot of others-- help me understand how valuable that structure is to the government, and is it being used increasingly; is it less important because of Australia's current domestic economic situation, et cetera?

HEARING CO-CHAIR CLEVELAND: If you can answer that, I'm going to be amazed because--

[Laughter.]

HEARING CO-CHAIR WESSEL: I know he can.

HEARING CO-CHAIR CLEVELAND: No, I'm just trying to understand what the question was.

HEARING CO-CHAIR WESSEL: The question was--

HEARING CO-CHAIR CLEVELAND: Or many, it seems.

HEARING CO-CHAIR WESSEL: No, no. There were a lot of statements. The question was about the net economic benefit test and what is its importance in terms of definitions, et cetera, and how the country is now looking at it?

MR. HUBBARD: Thank you very much, Commissioner.

I'll just firstly say that I won't answer this as a former Treasury official, but I will answer the question privately as an academic on the subject. Maybe it would just help everybody here or I'll just give a very brief thumbnail of what the Australian foreign investment regime looks like. Since 1976, Australia established the Foreign Investment Review Board and the role of that board is to advise the Treasurer of Australia on whether certain investment proposals should be blocked where they are deemed to be not in the national interests.

So there's, unlike Canada where it needs to be proved that there's a national benefit, we've got a negative test where we presume that it is in the national interests unless something shows that it's not.

As an interesting point, though, on that, in 1976, what we were concerned about at the time there and why we introduced the Foreign Investment Review Board was because of concern about foreign investment from the United States of all places. So it's certainly not a China specific thing.

What is China specific, if not by intent, at least by the way that history has turned out, is that while private companies from the USA, from China, from other free trade agreement partners, can invest up to $1 billion or so without requiring that review. All state-owned enterprises, or foreign government investors, as we call them, are required to submit to review from dollar zero. So any investment of any size from any state-owned enterprise from any government is required to undertake that review.

Now, that said, Australia and successive treasurers have by and large welcomed Chinese investment. They even welcomed Chinese investment from state-owned enterprises, even welcomed state-owned enterprises who are the largest enterprises. I'm talking about the state grids, the Sinopecs, the big oil companies. So the biggest, most strategic, most politically connected ones have come in, if you like.

And on the other side, it's an interesting phenomena that in the course of building a national broadband infrastructure in Australia, there was some consideration about whether the Chinese company Huawei would be allowed to bid to provide for that, and I think following some United States' considerations, the government decided not to allow Huawei to bid in that.

Now that wasn't a Foreign Investment Review proposal. That was a completely separate thing, but it's interesting there that Huawei according to their classifications is not a state-owned enterprise, and so if you're thinking about what are the threats that we're looking at or what are the threats that countries should be looking at when screening investment or dealing with foreign companies, really it's the case that the distinction between what is formally SOE and formally not SOE may not be the most helpful one.

Maybe if you've got any particular follow-up you're interested in?

HEARING CO-CHAIR WESSEL: My time is up. I'll have some other questions if there is a next round.

HEARING CO-CHAIR CLEVELAND: Commissioner Tobin.

COMMISSIONER TOBIN: Thank you, Madam Chair.

I want to direct my question to begin with to Dr. Zheng, and then I think when I get to the question, if others of you have thoughts, I welcome hearing them too.

You said that the nature of SOEs has changed. It's no longer the government's alter ego, and then you went on to say there are commercialized entities, and you talked about TPP, and there being a chapter, an extensive chapter in there on SOEs. And then one of your conclusions is we're both overinclusive and underinclusive. At the end of your written testimony, you say, "In light of this institutional environment, U.S. laws and policies that single out Chinese SOEs on the basis of government ownership alone are currently [sic] misleading."

So to you I ask, we reflect over the next four months as a Commission; we digest what we've heard today and consider what specific recommendations we will present to Congress or to other government entities. So given what you've said about our being overinclusive and underinclusive, and what would you recommend?

DR. ZHENG: My immediate recommendation would be to take out that chapter on SOEs from the TPP. That is counterproductive because by having a chapter on SOEs only, you're overlooking all of the special advantages that may be given to private firms in China, and you're assuming that all SOEs warrant this close scrutiny simply because they're owned by the state, which hopefully through my testimony I made it clear is not true anymore.

So that's my immediate recommendation, but of course I'm not sure that it can still be done now that the treaty has been concluded, but maybe for future considerations.

And there are more examples of specific U.S. laws that treat SOEs differently than private firms, but I think I will relieve you from the cruelty of going through this legal analysis.

[Laughter.]

DR. ZHENG: So more specific examples can be found in countervailing duty law--

COMMISSIONER TOBIN: Yes.

DR. ZHENG: --and antidumping law. So rewriting those statutes will require more extensive discussions. But I think the general proposal from me is treat every firm in China in the same way because of the institutional environment in which every firm behaves similarly.

COMMISSIONER TOBIN: And Mr. Hubbard, in your recent remarks, you were beginning to talk about distinctions, making distinctions. Do you want to comment on that in relationship to a recommendation? What would you recommend?

MR. HUBBARD: Distinctions between?

COMMISSIONER TOBIN: You have your Review Board and you look at what would be problematic, and you must have some test of some kind.

MR. HUBBARD: Yes.

COMMISSIONER TOBIN: What criteria do you use?

MR. HUBBARD: Sorry. According to the legislation, it refers just to this national interest, but the successive governments have tried to specify or lay out what they're interested in in terms of assessing the national interest with respect to state-owned enterprises. And what the test is goes to commerciality. So tries to look at is this investment proposal a commercial proposal or is it a strategic/political proposal that may be against Australian national interest?

But by and large, if an SOE is investing in Australia for commercial reasons, according to commercial logic that its corporate governance structures are such that it's sort of recognizable to sort of Australians as a commercial firm, then it's by and large accepted.

COMMISSIONER TOBIN: And Dr. Hsueh. Thank you.

DR. HSUEH: I think perhaps a focus on SOEs is too limiting. I agree with that. I do think, though, state ownership continues to dominate in certain infrastructural sectors, and so I think taking a sectoral perspective might be, I think, most pragmatic for the United States.

COMMISSIONER TOBIN: Did you say sectoral or--

DR. HSUEH: Sectoral as an in sector.

COMMISSIONER TOBIN: Sectoral.

DR. HSUEH: Yeah. Industrial sectors.

COMMISSIONER TOBIN: Thank you.

DR. HSUEH: And not just looking at kind of macro aggregate industries. If you take telecommunications, for example, not all of telecommunications subsectors have predominance in state ownership. And so there's divisions between equipment makers, and even among equipment makers, you have the consumer equipment makers versus networking equipment.

In the service sector, you have operators infrastructural asset, all state-owned operators, across different market segments, but then you have value added services, which is largely privately owned but state backed and certainly state intervention in some of those sectors.

And most recently, for example, there was announcement of this collaboration between China Telecoms and Alibaba to get together and identify together strategic companies for both companies to collaborate with, and so that's an example of an operator working with a value added service provider that's a private company but has received a lot of state backing.

COMMISSIONER TOBIN: My time is up, and I want to make certain we have time for others. Thank you.

DR. HSUEH: Okay. Thanks.

COMMISSIONER TOBIN: Maybe second round I can hear more.

HEARING CO-CHAIR CLEVELAND: Senator Dorgan.

COMMISSIONER DORGAN: Thank you very much. First of all, thanks for participating in the hearing.

And Mr. Zheng, with respect to your discussion about the rules, I understand that. I'm always much more interested in how things really work as opposed to what is written somewhere, and I think you touched on that some. Even though the rules might not require Party association on a board, if you're running the right kind of company or the wrong kind of company in China, you're going to want the influence that comes with having a board. So I'm just always interested in how it really works. What's going on.

So let me ask, I was really interested in the issue of direct foreign investment and the increase in direct foreign investment, which represents a Chinese strategy. I also note that the large direct foreign investment is coming from firms that, at least according to some of this testimony, that have very substantial debt. And that suggests and means that direct foreign investment bids on companies in this country or elsewhere, especially with state-owned enterprises, are necessarily backed by the government of China. So, how do you see that squaring with the WTO and what we would expect normal trade relationships to be?

If you have a direct foreign investment acquisition proposed by a company that has substantial debt backed by the government, how does that square with what we now expect our trade relationship with China to be?

DR. ZHENG: So I'm not sure if I understand your question correctly, so I hear the question to be whether a foreign direct investment backed by the Chinese government in terms of financing complies with the WTO requirement?

COMMISSIONER DORGAN: Right.

DR. ZHENG: In my view, that would depend on the circumstances and also the sector in which the investment is being made. Now, you are absolutely correct that many of the foreign direct investment deals made by Chinese firms are backed by the government, you know, not only the SOEs. If you look at the private firms, for example, Geely you know, when it acquired Volvo, a large percentage of the money was being financed by the local governments in China.

But that in and of itself does not violate China's trade obligations under the WTO. You know as important as the WTO is, it is a very limited international treaty. It has nothing to say in this regard about whether the state, whether the government can provide financing for foreign investment transactions.

Now, it could violate or it could give rise to trade remedy action that is brought within the framework of the WTO if the foreign invested firm exports products to countries like the U.S. For example, if Geely after acquiring Volvo started producing Volvo cars and exported those cars to the U.S., and if Geely continues to receive low-cost financing from the government, then U.S. car industry could petition the government, the U.S. government, to launch countervailing duty investigations, and the low-cost financing provided by the Chinese government could become a basis of imposing countervailing duties on Chinese imports.

So that is the situation in which I can think of that has some impact on WTO, but other than that, I think in itself the government financing is not a problem from a WTO perspective.

COMMISSIONER DORGAN: All right. Well, these are, I mean you're talking about the longer-term plans and how the private sector and the government-sponsored enterprises, or government-owned enterprises, are working in the same way for the same central interest in China. And even though one, I think your, Mr. Hubbard, your testimony really is testimony that describes that the state-owned enterprises are really not the principal domestic, domestically, at least, are not the giants that we presume them to be.

On the other hand, it is state-owned enterprises that are largely involved in direct foreign investment; is it not?

MR. HUBBARD: That's the case largely because of the sectors in which the foreign investment have been are the sectors that are still state dominated.

COMMISSIONER DORGAN: So let me just mention to you. I have been in long, long, long conversations with a private businessman in China, and I won't go through case work here. I was not directly involved, but I know the case in a very significant way as someone decided to build oil facilities for the transportation of oil in an area that looked promising but was not the most promising area.

It turned out to be one of the most promising areas after he had built the facilities, and then he was put in prison for four years with no charge, and in the meantime in the several companies he owned, the government in China brought in a new board, took his assets away, and when all of that was completed, the government had a state-owned enterprise that had been built in private hands, and the person that built it had nothing.

And none of it really is much a part of the public record except the fact that he was taken away from his family for four years, and his assets were stolen. And so in terms of knowing how things work with respect to the government, the Party, state-owned enterprises, and the private sector is really important.

I think changes are happening in China that tell all of us there are some positive things happening. No question about that. If you've been there over a period of years, as I have, there's movement in the right direction.

But there's also a lot of disruptive behavior that we would be very aghast to learn about. So this discussion today is I think really interesting because putting this notion of capitalism in China in a larger construct so that we begin to understand what it is that we're competing with--this is an international competition after all for jobs and growth and so on--your ability to come and testify and put this in a slightly larger context is very helpful to all of us.

Thank you.

HEARING CO-CHAIR CLEVELAND: Commissioner Brookes.

COMMISSIONER BROOKES: Thank you.

Dr. Hsueh's testimony kind of piqued my interest in this, but I open it up to the panel if they have anything else to say on it. You mentioned the strategic sectors, national security sectors. How does the defense industrial complex operate within China? I mean we don't have forever to talk about that, but how do they operate? Do they operate differently than the rest of the state-owned enterprises? Is there anything that's outside of state control that operates in the military industrial complex?

Is there competition between different parts of the military industrial complex? So if you could say a few things about that, I'd appreciate it, and anybody else that may have a comment as well.

DR. HSUEH: Thanks for that question.

What I was referring to were mostly dual-use technologies and dual-use industries so telecommunications, for example, would be one that could be--that is both part of the military industrial complex but at the same time also very consumer oriented and obviously are part of the communications infrastructure.

In terms of the People's Liberation Army, I mean, you know, because of--and there has been lots of scholarship on the PLA and the transformation of the PLA and the impact of market reforms on the PLA. David Shambaugh over at George Washington has written extensively before and also most recently on these issues, and so traditionally or historically with market reforms and the devolution of economic decision-making in certain issue areas, that became less important.

The PLA was able to get into business and started operating hotels, you know, restaurants, and so forth. But obviously those are in issue areas that are not going to be of much national security concern, and so--but in other sectors, even in the decentralized industries, such as textiles, when we think textiles, we mainly think clothing and apparel, but we have subsectors in technical textiles that actually do, in fact, have a lot of input into the military industrial complex, and in those subsectors, geosynthetics, manmade fibers, you know, the manmade fibers that enabled China to go into space, those were Chinese-made fabrics for the astronauts.

And so even a sector such a textiles, which has been decentralized, and the Ministry of Textiles was dismantled in 1993, there are certain areas, issue areas and sectors, that is still closely connected to military applications, and so those areas are going to be of much more concern to the Chinese government.

And so I guess my conceptualization of the military industrial complex is that it is more and more very much integrated into the larger economy, but it's going to depend on which market segment, which subsector we're talking about in the larger economy, and those national security applications and applications to the national technology base are going to be the ones that the government will pay more attention to, not so much as, oh, there's a separate military industrial complex economy that's in existence in China. I think it's integrated, but the government cares about all these different sectors that have those applications.

Thank you.

COMMISSIONER BROOKES: Anybody else have?

DR. ZHENG: If I could add to that, you know, the military and industrial sector is a sector that I have not done a lot of research on so I don't have any specific insights on that industry, but I think it is conceivable that the Chinese government retains or at least tries to retain more control over that sector because of its strategic value.

But what I identified in my testimony, you know, the problems that I call agency costs, I think also exists in that sector. So even if the state wants to have more control, it does not necessarily mean that the state can do that because it has to rely on agents, and you have to monitor the agents, and whenever you don't have, you know, effective monitoring, the control mechanism will break down. So I think it's important to note that you really cannot have complete control even for the military sector. That's my general view.

MR. HUBBARD: Just a footnote on all of that. Some of the 106 central SOEs that I mentioned are specifically the arms manufacturers or defense industries. They are very special case SOEs that are much less transparent than other central SOEs even. And I think even if we, our economists, got everything they wanted on SOE reform, you'd still end up with a small number of SOEs in that area kept very close to the state.

HEARING CO-CHAIR CLEVELAND: Commissioner Shea.

CHAIRMAN SHEA: Thank you.

This has been really interesting testimony. I have two questions. One is a clarifying question, and then I have a second question on dividends. But is it my understanding, particularly from Dr. Zheng and Dr. Hsueh--that's easy for me to say, Dr. Hsueh--you're basically saying with respect to Chinese investment in the United States, just assume everything--anyone who presents themselves from China, any institution, private or state-owned, assume they're influenced by the Chinese government. Is that fair to say?

DR. ZHENG: That's a fair characterization of my review. So you have, you know, the baseline is everybody is influenced by the government in China. You cannot really find a successful firm that doesn't have good relationship with the government.

CHAIRMAN SHEA: So the push-comes-to-shove test, the Chinese government wanted something, they will get it regardless of whether it's a state-owned or mixed-owned or private-owned? Is that correct?

DR. ZHENG: In my view, that would be the correct baseline presumption. Of course, that presumption can be rebutted by--

CHAIRMAN SHEA: Right.

DR. ZHENG: --specific evidence, but without any specific evidence, the presumption is that if the government wants something, it will be able to get it, whether you're talking about SOEs or private firms.

CHAIRMAN SHEA: I mean it seems impossible--CFIUS is a 90-day process or 120-day process--for the U.S. government to explore the ecosystem, as you mentioned, in China around upon which this entity is established would be an impossible task. So are you suggesting then that the U.S. government--I heard the word "sectoral" mentioned--that the U.S. government, when a Chinese entity seeks to make an investment in the United States and voluntarily submits an application to CFIUS, that the U.S. government assume it's government, Chinese government, controlled or influenced and then just sort of makes a judgment as to whether we want the Chinese government investing in a specific sector of the U.S. economy? Is that sort of the judgment the U.S. government should make?

DR. ZHENG: Now I want to clarify this a little bit. I'm not saying that we should assume that the Chinese government has a controlling influence on all firms that are making the investments. I'm only saying that we should assume that the degree of influence on the part of the Chinese government over the firms that are making investments in the U.S. is more or less the same.

So what is the degree of the influence? Is that to a point where the government can reorder or force the company to do something that is only good for the government itself? That is a fact-intensive inquiry that would depend on the specific circumstances. So it could be that the government has more or less the same influence over a Chinese firm, but that influence is negligible.

I would say that is true in many situations. The government has been out of the day-to-day operations of Chinese companies in a large percentage of the cases, I would say. But whether that would pose national security concerns, that would be--

CHAIRMAN SHEA: It's a sector. If they're investing in movie theaters, maybe that's not a national security--

DR. ZHENG: Exactly. So that may depend on the sector. So--

CHAIRMAN SHEA: Yeah. Okay. I won't--

DR. HSUEH: Would you mind if I--

CHAIRMAN SHEA: Sure.

DR. HSUEH: Yeah. What I would add to that is that, yes, I actually, I do agree that it's going to be by sector. We cannot assume that the Chinese government is involved in every outbound investment. And, for example, certain firms listed abroad in the textile clothing and apparel sector, Bosideng in Hong Kong, for example, those are companies that the Chinese government in their development at the local Party level and the local level may have assisted in the development of through market tools, but certainly the government was not involved in getting investment abroad.

CHAIRMAN SHEA: Okay.

DR. HSUEH: Yeah.

CHAIRMAN SHEA: I have a very short time. Question on dividends. As Dr. Zheng pointed out in his testimony, the state-owned enterprises only pay five to 15 percent, dividends at a five to 15 percent rate, which is very low. I believe the Third Plenum signaled an intent to raise the dividend rate to 30 percent.

DR. ZHENG: Yeah, that's right.

CHAIRMAN SHEA: But how much are these dividends--in order to basically stimulate domestic consumption, to provide, help fund security, social safety net, use SOE dividends to fund a social safety net, which would stimulate a rebalance, more domestic consumption. But how much of these dividends are actually being recycled back to the SOEs in the form of subsidies?

DR. ZHENG: Well, the answer is a lot of them. So I have a number, but I'm drawing a blank on the number, but more than 90 percent according to one estimate is being recycled back to the companies themselves in all forms of subsidies.This doesn't even include all of the other subsidies that SOEs are enjoying. For example, the subsidies in the form of low-cost land use rights, and if you include those subsidies, the SOEs are actually getting more than what they are paying to the government in terms of dividends. So--

CHAIRMAN SHEA: Okay. Thank you very much.

HEARING CO-CHAIR CLEVELAND: Commissioner Bartholomew.

VICE CHAIRMAN BARTHOLOMEW: Thanks, again.

This is really interesting. And in the spirit of Senator Dorgan saying understanding how the structure and the processes work is really important, I think it's really important how the label is done. So I was thinking, it's probably about 15 years ago, people started talking about GONGOs in China, the government organized non-governmental organizations. There's a contradiction inherent there.

And I'm just wondering, Dr. Zheng, in particular, if we need to start talking about non-private private companies because Americans hear private companies, they think something different than what is really taking place. So perhaps we need to reconsider what we call these entities that are so-called "private companies."

But I was really wondering, two of you, I think, were talking about removing references to SOEs because it doesn't encompass enough, which is in some ways--I hate this cliche--throwing the baby out with the bathwater, and I wonder if there is some way to expand those things to include these non-private private companies or these other activities that are going on rather than just simply removing the references to SOEs? I wonder if you've given any thought to that?

DR. ZHENG: I think you're absolutely right, that we should start thinking about labels, to an extent labels are useful, we should start thinking about labels like non-private private firms or private non-private firms.

[Laughter.]

DR. ZHENG: But I think a better approach, though, will be just to discard all the labels so just treat the firms the way they are. I think the basic reality here is just ownership alone doesn't really say a lot anymore about Chinese firms. So any labels based on ownership in terms of, for example, public or private, doesn't really have a lot of meaning today. So maybe a better approach would be just to move beyond the labeling stage and just to treat all of them the way they actually behave in the economy.

VICE CHAIRMAN BARTHOLOMEW: Mr. Hubbard, you look like you wanted to say something.

MR. HUBBARD: I looked puzzled. I think there is still, I mean there's still certainly good analytical reason to maintain the distinction. I mean if you look at the, just the financial returns for SOEs versus non-SOEs, you can't say, well, we can't tell one from the other. It's obvious that SOE returns when compared with private returns in most sectors are a lot lower, and you can think of private firms with people putting up their own money in a sort of economic textbook way as profit maximizers. And you can think of SOEs perhaps where SOE heads are part of a broader career structure with different incentives. They might behave more like asset maximizers. They're interested in growing bigger within a short time rather than being as profitable as possible.

So I think the behavior of the firms is quite different, and you can see that. I think what we get caught up at is the point that let's say the Chinese government meant to do some sort of strategic harm to anybody. They're not going to be squeamish about using a private firm rather than an SOE to do it. So I say in the Australian context, if China meant Australia strategic harm, it's not going to wrap it up in a big red box marked "SOE" on the outside, attach a billion dollar check and submit it for foreign investment screenings.

But the idea that behind every Chinese private firm is the hand of the Party and the state, and that there's some harm intended there, I think that would be a mistake because I think that would be putting your hands up and refusing a lot of good capital from provincial SOEs, from a lot of things that have got absolutely no strategic importance and no connection. I think there's a lot of money there. It's worth taking an investment, and it's worth engaging with SOEs, getting them used to behaving in competitive markets where they don't get special privileges, that are well-regulated, because those learnings go back to how business is done in China. It's a way of engaging with China, not just to get the capital, but it's a way of making sure that international business standards, international accounting standards, international standards of transparency are sort of learned back the other way, and I think that's--

VICE CHAIRMAN BARTHOLOMEW: We certainly have a long way to go, particularly on the accounting standards, but--

MR. HUBBARD: Yeah, but it's amazing what Chinese local firms learn when the independent auditors come in.

DR. HSUEH: If I may make a comment about ownership? I don't think that we should abandon ownership levels entirely. I think it's important to recognize it's no longer the most important factor in that we should still continue to understand the distribution of property rights within each firm, and the reason we need to continue doing that is because that allows us to understand the different interests, the different stakeholders, and what interests they may have, which will then affect behavior of firms.

And it's also important to understand the institutional environment. Is it local government that's the owner or is it the provincial government or is it a central level national level company? And by understanding these different interests, then we understand the behavior of the firms better.

VICE CHAIRMAN BARTHOLOMEW: Thanks.

DR. ZHENG: If I can quickly add, so there's absolutely no doubt that a government-owned firm behaves a little differently than a private firm. I'm not saying that we shouldn't consider ownership at all in all respects. And I agree with Dr. Hsueh that we need to continue to look at the distribution of property rights. What I'm saying is that just labeling the firm as "SOE" or "private" doesn't really help at all.

For example, if the Chinese government has ten percent of ownership interest in a firm, and all of the other private holders have eight or nine percent, do you call that firm an SOE or private firm? It doesn't really help at all, you know, that labeling. So that's what I mean.

VICE CHAIRMAN BARTHOLOMEW: Thank you.

HEARING CO-CHAIR CLEVELAND: Commissioner Wessel.

HEARING CO-CHAIR WESSEL: I agree with that. I think if you look at Carl Icahn who doesn't have controlling stakes, he's influencing a number of firms here and their activities. So control influences a facts-and-circumstances test.

DR. ZHENG: Exactly.

HEARING CO-CHAIR WESSEL: Dr. Zheng, I'd like to ask a question relating to the impact here of the SOEs or those entities that are part of the Chinese ecosystem. We have transactions here, Syngenta, a number of others that you've probably read about going on, and you have Tianjin Pipe, a billion dollar state-owned Chinese pipe and tube facility, that has built a blast furnace and finishing facilities in Texas.

You talked earlier about if the product is traded across borders, CVD, countervailing duty laws, can apply.

DR. ZHENG: Yeah.

HEARING CO-CHAIR WESSEL: My understanding, and I'd like your comment, is with a greenfield or an acquisition here in the U.S., the trade laws don't apply if the product is produced here in the U.S., and, in fact, if the inputs come here because they don't enter commerce under the traditional freely traded standard, they may not be at arm's length. You have transfer pricing issues, et cetera. That the SOEs or Chinese investments in facilities here may be creating substantial competitive challenges for existing U.S. entities or players in the U.S. market, and Clayton, Sherman, Lanham antitrust statutes don't apply. Have you looked at this at all? Do you have any comment? Or if not, can you get back to us on your thoughts?

DR. ZHENG: That's a very good observation. So I agree with you that if the products are produced here in the U.S., trade law doesn't really help because that doesn't raise cross-border trade issues. Whether the U.S. can use other laws, you know, like antitrust laws, that is something that I haven't looked into, but I'd be happy--

HEARING CO-CHAIR WESSEL: If you could because--

DR. ZHENG: Yeah.

HEARING CO-CHAIR WESSEL: --let's take again Tianjin Pipe, the last bond issuance, as I understand it from U.S. Steel, a competitor, was 5.7 percent. Tianjin Pipe is state-owned, may have no cost of capital. So should that benefit be actionable?

Under current law, my understanding is it's not. Do we have to look at these challenges in new ways with the dramatic flow of investment?

DR. ZHENG: I believe we may get to a point where we need to rethink U.S. law regarding this, not necessarily international trade law.

HEARING CO-CHAIR WESSEL: Right.

DR. ZHENG: So we'll probably have to think about how domestic U.S. laws should be reformed to take into account this situation. How we can think about federal law or state law that would be targeting these kind of unfair practices, not necessarily unfair international practices. Yes.

Actually whether we are at this point now, I'm not sure. So maybe the scale of Chinese investment that raises this kind of issue is not big enough yet, but we may be approaching that point. Yes.

HEARING CO-CHAIR WESSEL: Syngenta is $43 billion.

DR. ZHENG: Uh-huh.

HEARING CO-CHAIR WESSEL: That to me rises to the level that it should start raising questions. It doesn't mean there's anything bad about the transaction, but as I think Commissioner Shea said, it's a 90-day review.

DR. ZHENG: Yes.

HEARING CO-CHAIR WESSEL: It's a little hard to understand the ecosystem, all the inputs and the pricing issues and what it may mean for U.S. capitalism--

DR. ZHENG: That's right.

HEARING CO-CHAIR WESSEL: --without a broader analysis of all this. So what you and the other panelists might be able to do and get back to us would be helpful.

DR. ZHENG: Thank you. You just identified an excellent topic for a very good law review article.

[Laughter.]

HEARING CO-CHAIR WESSEL: Well, since your article with Dr. Milhaupt was recommended to me by the USTR, I can tell you that the there are people in the U.S. government who are looking actively at what your work is. So I commend you to do the article.

DR. ZHENG: Thank you.

HEARING CO-CHAIR CLEVELAND: Commissioner Tobin, did you have another?

COMMISSIONER TOBIN: No.

HEARING CO-CHAIR CLEVELAND: Okay. Anybody else? Senator Dorgan.

COMMISSIONER DORGAN: Just one additional quick question. With respect to direct overseas investment, are there reciprocal opportunities between the U.S. and China with respect to direct overseas investment? If Toys "R" Us America decided to go buy Toys "R" Us in China, could they, could we make an investment and purchase the acquisition? I mean 100 percent control of a Chinese company? Is there a reciprocal opportunity?

DR. HSUEH: I mean certainly, you know, of course, I'm going to go back to it will vary by sector. And I mean it was mentioned earlier about the automobile sector, automotive sector, and the varieties of property rights in automotive within China. But one particular rule is that for foreign direct investment in the auto sector, these foreign companies have to form joint ventures, joint ventures with either the national level government owner or local government owner, and so in automotives, for example, auto companies do not have reciprocity.

COMMISSIONER DORGAN: But isn't that true much more generally than the auto industry?

DR. HSUEH: Exactly. So what I'm trying to say, that it will depend on the industry, and I think, you mentioned toys. Toys is a deregulated industry in China in manufacturing certainly. A U.S. manufacturer could go and buy a toy manufacturer.

In the services end of manufacturing of toys, the retail of toys, it will depend on market entry laws in retail.

COMMISSIONER DORGAN: All right. Thank you.

HEARING CO-CHAIR WESSEL: But just as a related question, retail is regulated in ways. So Toys "R" Us in the retail area--

DR. HSUEH: Yes.

HEARING CO-CHAIR WESSEL: --might find certain restrictions.

DR. HSUEH: Right. And of course you do see that in India as well.

COMMISSIONER DORGAN: Well, my understanding is that's true in most sectors. If the Wessel Toy Company wanted to purchase--

HEARING CO-CHAIR WESSEL: I can assure you the Wessel Toy Company would not get into China.

[Laughter.]

COMMISSIONER DORGAN: All right.

HEARING CO-CHAIR WESSEL: Thank you.

COMMISSIONER DORGAN: All right. Thank you.

CHAIRMAN SHEA: Well, my understanding is that there are areas that they encourage investment. There are areas where they restrict investment and maybe condition it on these joint ventures, and there's areas where it is completely prohibited.

COMMISSIONER DORGAN: Yeah, it would be good to know much more about that. In terms of where they even encourage investment, what percent of the company that they purchase can they control? And so I know there's a lot of circumstances where companies that are not involved in national security issues, you can't go purchase 51 percent of that company. They'll allow you to purchase 49 percent, which is--so that's something we can explore later, but thank you for the answer.

MR. HUBBARD: If I could just add something that perhaps as an economist thinking about these things, it's hard to see why insisting on a principle of reciprocity would be in the United States' interest. I mean just because that China for either vested interest or to protect its own political structure wants to close off various aspects to investment doesn't mean that it wouldn't be in the United States' own interests to welcome foreign capital into those areas.

So I think reciprocity, particularly with a very, very large, and very, very complicated developing country, I think it would end up harming the U.S. unnecessarily. I think the U.S.'s great strength is its openness, and closing off the U.S. because China wants to do is sort of cutting off one's nose to spite one's face, I think.

VICE CHAIRMAN BARTHOLOMEW: Right now I feel I need to comment, which is you did give a very economist point of view, and I'm actually pleased to hear that you didn't invoke Smoot-Hawley, which seems to every time we talk about something like reciprocity, people say trade war, trade war, trade war.

But, nonetheless, Mr. Hubbard, reciprocity, which is fairness in and of itself, also could provide leverage for the opening of markets in China, which is if they want access to some of our things, and we can't get access to some of their things, so our companies are shut out, if we were to say you don't get to come in and buy these things here unless our guys have the same opportunity in your country, it might provide leverage in order to make some of that happen.

MR. HUBBARD: Yeah, reciprocity is a negotiating tactic, but I mean as we heard in the first panel, the Chinese reform is slow and painful and things are announced and can take years or decades to happen, if at all, so I'm not sure whether the cost-benefit on that is worth it for the U.S. I think being clear with the principles of what has made the U.S. economy so successful and sticking by that is probably a better example for Chinese reformers than--but I'm not a negotiator.

DR. ZHENG: If I could add to that, you know, the question of to what extent U.S. investment, you know, U.S. firms can invest in China, I agree with the other commentators, that question varies from sector to sector, and it's largely determined by the Chinese government itself. But in some instances, at least, that question, the Chinese government would be subject to discipline under the GATS agreement of the WTO, the General Agreement on Trade in Services.

China has made commitments on what kind of foreign investments will be permissible in China. So the U.S. actually won a WTO against China on union pay, the credit card services industry. So that is one thing the U.S. has the legal tools to enforce China's commitments.

And also, in terms of reciprocity, the current negotiations on U.S.-China Bilateral Investment Treaty, that is a wonderful venue to achieve reciprocity. You know the U.S. can push China what kind of investments it wants to make in China in order for Chinese investments to come to the U.S. That's the platform to talk about reciprocity, the bilateral investment treaties.

HEARING CO-CHAIR CLEVELAND: All right.

HEARING CO-CHAIR WESSEL: Do you really want a response?

VICE CHAIRMAN BARTHOLOMEW: No, don't, don't, don't.

HEARING CO-CHAIR CLEVELAND: Bilateral investment treaties are never mentioned without a comment from Commissioner Wessel.

HEARING CO-CHAIR WESSEL: Go ahead.

HEARING CO-CHAIR CLEVELAND: We're done? Okay.

HEARING CO-CHAIR WESSEL: Sure.

HEARING CO-CHAIR CLEVELAND: Thank you very much. Your testimony I think based on the response from the commissioners really will help us as we think through the final report this year. I think you've changed our vocabulary if nothing else and how we approach the whole question of--

VICE CHAIRMAN BARTHOLOMEW: Non-private private companies.

HEARING CO-CHAIR CLEVELAND: Non-private private, yes. I'm not sure we'll go in that direction, but I--

HEARING CO-CHAIR WESSEL: I'm on secret probation.

HEARING CO-CHAIR CLEVELAND: Yeah. I do think that you have revealed a way of thinking about this that will be very, very helpful to us. So thank you all.

VICE CHAIRMAN BARTHOLOMEW: Thank you.

DR. ZHENG: Thank you.

HEARING CO-CHAIR CLEVELAND: So we'll be back at--

HEARING CO-CHAIR WESSEL: One o'clock. Right? That's--

HEARING CO-CHAIR CLEVELAND: We will be back at one o'clock.

PANEL III INTRODUCTION BY COMMISSIONER MICHAEL WESSEL

HEARING CO-CHAIR WESSEL: Good afternoon. Welcome back. Our third panel today will explore the causes and scope of China's overcapacity problem and assess impacts on U.S. and global firms and industries.

First, we'll hear from Mr. Terrence Stewart, Managing Partner of Washington-based law firm Stewart and Stewart. Mr. Stewart's practice focuses on international trade matters, including trade remedies in the United States and abroad; protection of trading rights within bilateral, plurilateral, and multilateral fora; customs law; litigation and dispute settlement proceedings for trade agreements; and studies of conditions in major trading partners such as China.

He has written extensively on and edited numerous publications concerning trade relations with China, among many other topics. He has testified before the Commission several times and welcome back, Terry, and I also have your GATT/WTO books on my shelf. I haven't read them recently, but they are a great resource.

Next we have Mr. Jeremy Haft. Mr. Haft currently serves as CEO of SafeSource Trading, an export firm that brokers sales of American agricultural products to China.

Mr. Haft is also Co-founder and Principal at Caracal Strategies, a global market access and public affairs firm based in Washington, D.C., Brussels, and Beijing. Additionally, he lectures as an adjunct professor at Georgetown University's Walsh School of Foreign Service and McDonough School of Business.

Mr. Haft is the author of the 2015 book, Unmade in China, which examines America's enduring competitive advantages over China in the coming century, and the 2007 book, All the Tea in China: How to Buy, Sell, and Make Money on the Mainland, which details best practices for importing, exporting and doing business in China.

Finally, we welcome Mr. John Ferriola, Chairman, CEO and President of Nucor Corporation. Your predecessor used to send me a lot of red capitalized e-mails so it's good to meet you finally.

Mr. Ferriola--those in the room who--

HEARING CO-CHAIR CLEVELAND: Capital letters.

VICE CHAIRMAN BARTHOLOMEW: All capital letters.

HEARING CO-CHAIR WESSEL: He only speaks in capital letters, I think; right?

[Laughter.]

HEARING CO-CHAIR CLEVELAND: Red capitals.

HEARING CO-CHAIR WESSEL: Mr. Ferriola joined Nucor in 1991, serving in various roles throughout his tenure. Notably, he was appointed as Executive Vice President in 2002, and in 2007 was named Chief Operation Officer of Steel Making Operations. He became President and Chief Operating Officer and a member of the Board of Directors in 2011, before assuming his current role in 2013.

In addition to leading Nucor Corporation, Mr. Ferriola currently serves on the Board of Directors for two new Nucor joint ventures as Vice Chairman of the Board of Directors of the American Iron and Steel Institute, and as Vice Chairman of Worldsteel. He began his career with Bethlehem Steel Corporation in 1974 and worked for 17 years in various operating and management roles.

I'd like to note that in addition to our witnesses today we have additional written testimony submitted by Century Aluminum Company, which can be found on our website at www.uscc.gov.

And we will start with Mr. Stewart. Our normal rules are seven minutes. Please stay close to that, and then we will have a robust round of questioning. Terry.

OPENING STATEMENT OF MR. TERRENCE STEWART
MANAGING PARTNER, STEWART & STEWART

MR. STEWART: Thank you, Commissioner Wessel, and it's a pleasure to be back.

I'm going to deviate from my script and will keep it within the seven minutes so I won't be usurping other people's times. On Monday of this week, a major report came out from the European Chamber of Commerce in China that looks at overcapacity and looks at six or eight industries that are suffering excess capacity, substantial excess capacity.

The reality in China is, is that there are dozens of industries that have excess capacity, but the ones that are identified there are ones that have been on the books and suffering the problems for an extended period of time. That report does an excellent job of identifying both how the industries got to those problems and why the efforts of the Chinese government to rein in the excess capacity have in many instances failed.

The three primary causes that get repeated over and over again is the distinction between what the central government has ordered and what the local governments are willing to implement because of the potential both tax and employment repercussions; two, the general challenges that China has in terms of implementing and enforcing rule of law in their own country so that various standards that should have eliminated a lot of the excess capacity simply don't--haven't worked in many of the sectors; and then three, the contradictory policies that China often has where it may be trying to restrict capacity in certain parts of the country in certain sectors while at the same time authorizing expansions of capacity either for geographical diversity to help develop the Western part of the country or what have you.

So those problems repeat themselves over and over and over again. My prepared statement goes through what the implications for what is really an unprecedented set of problems that have grown over the last 20 years out of China. Basically, you cannot find a parallel situation in history. Never before has there been so much excess capacity in so many industries driven by the policies, however well intentioned and however internally focused in many ways, as have been generated by China.

And the problem when that occurs, first and foremost, obviously, is one for China to try to deal with, and they have gone through some periods where there have been massive layoffs that they've had to deal with, et cetera, but any time and for the rest of the world where the products are being traded, and not all of the industries in which there are substantial excess capacity does China engage in significant exports, but obviously in industries like steel, aluminum, tires, paper, these are industries where there have been and continue to be major problems.

When you have a situation of massive excess capacity globally, it pushes players in other parts of the world to face the adjustment cost. China has been attempting to get adjustments done, but has failed, and that has meant that there have been tremendous costs incurred by other parts of the world.

One only needs to look at aluminum where you've had five smelters that have been closed or announced to be closed in the last six months in the United States and where our capacity in aluminum will shrink down to where we were six decades ago to realize that the pain can be enormous and the dislocations and disequilibrium that exists can be extraordinary and long-lasting if you cannot get at the core problem.

Now, the challenge is, is that when the GATT was established and the WTO after it, the rules were never established to deal with a problem of massive excess capacity because in market economies, while you can have periods of excess capacity, those tend to be typically recession related, and where they're not recession related, they tend to be because you've had governments that have engaged in the same kind of folly that the Chinese government has been engaged in, massive subsidization to expand and try to capture the world.

So the issue, I believe, that the Commission would be wise to try to help the administration and Congress address is how you deal with this problem quickly. First and foremost, it isn't going to happen quickly without significant cooperation from the Chinese, and there have been efforts by the Chinese.

In some industries they have been successful. In most industries, they have not. There's been a recent announcement of their policy to shut down a hundred, 150 million tons of steel in China, which is more steel than the United States has the capacity to produce but is only probably a third of the excess capacity that exists in China. Just in that one sector. I mean, you know, the numbers, the numbers are staggering.

We're in the middle of a case right now on truck and bus tires, and China has more capacity to produce truck and bus tires than there is demand in the entire world, and so you just sit there and you say what can happen?

So in my paper I identify a series of things that could be done in light of the fact that there are not more bilateral rules that permit rapid identification. Some of them involve encouraging China to do things and take exceptions at the WTO that would permit them to bottle up the problems so that it is, in fact, a China specific problem.

Or to permit trading partners to bottle it up for them if they're unwilling to do it themselves. Or to do WTO cases. The problem with those is the length of time they take and hence the problems that the rest of us will face and the losses that we will incur as that goes through.

Or to self-initiate cases or to make policy changes at the agencies, including one that's near and dear to the Chinese heart, which is to identify that there will not be an evaluation of whether they become a market economy player under the dumping law unless and until they have dealt with the excess capacity that they have built up in their industries.

So with that, I'll stop and turn it over to others.

HEARING CO-CHAIR WESSEL: Mr. Haft.

PREPARED STATEMENT OF MR. TERRENCE STEWART MANAGING PARTNER, STEWART & STEWART

February 24, 2016
Terence P. Stewart
Managing Partner, Law Offices of Stewart and Stewart
Testimony Before the United States-China Economic and Security Review Commission
China's Shifting Economic Realities
Panel III: Overcapacity and Global Markets

Generally, an economy that follows state planning has the ability to pour resources into industries on a scale that doesn't reflect underlying demand patterns or that overshoots actual demand trends. In the past several decades, a massive amount of industrial capacity has been added in China in a large number of manufacturing sectors to enhance the competitive position of the country and to provide employment to large numbers of people, many in state-owned enterprises. These actions have created massive disequilibrium in China and globally in various important manufacturing sectors. This imbalance was exacerbated by the 2007-2008 global financial crisis and recession and has again surfaced as a destabilizing force amidst slowing global demand. In fact, the US and many other countries are suffering the consequences of China's actions as seen in the closure of aluminum smelters and steel mills and the layoff of thousands of workers.

Indeed, the scope of the excess capacity in certain major industries is extraordinary by any measure and flows from state planning, funding and subsidization on a massive scale. The central government of China has recognized that the problem is a serious one and has been trying to deal with it, often with little actual effect as planned capacity closures are undermined by local governments focused on creating or maintaining employment and by central government efforts to add capacity in the western part of the country. So mandated closures have in many sectors been more than offset by other capacity additions in the country.[1] However, with the recent and increasingly slowing internal growth in China, the increasing capacity overhang in China is creating very real problems for Chinese companies and their international competitors. These capacity increases in a time of declining global demand are destabilizing global markets as exports have increased in some cases by 100% in short periods. The result is depressed global prices for products and waves of dislocations around the world as producers in other markets shift product to export[2] as they lose market share at home. Ultimately, China must play a leadership role in the global economy to help find a way to rebalance supply and demand in each of these sectors. While it is doing so, the sectors will be depressed around the world with companies, workers and their local communities paying the price for the massive excess capacity created and maintained by the Chinese economic system.

Because there are no multilaterally agreed rules to address situations of massive global excess capacity in a rapid or comprehensive manner, Chinese action now to get rid of excess capacity is

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[1] *See, e.g.*, Biman Mukherji, *Rising Chinese Production Keeps Lid on Aluminum Prices*, Wall Street Journal, Nov. 10, 2015 (noting that, since 2010, Chinese producers have closed 3 million tons of annual aluminum production capacity but have added an additional 17 million tons of capacity), http://www.wsj.com/articles/rising-chinese-production-keeps-lid-on-aluminum-prices-1447186082 (requires subscription). *See also Aluminum producers staggering as factories lack orders,* http://china.org.cn/business/2013-08/27/content_29835483.htm; *China's aluminum glut set to continue,* http://asia.nikkei.com/Markets/Commodities/China-s-aluminum-glut-set-to-continue.

[2] *Will China Finally Tackle Overcapacity?,* http://blogs.piie.com/china/?p=3857; OECD China Economic Survey (March 2015), http://www.oecd.org/eco/surveys/China-2015-overview.pdf.

critical to preventing the serious global dislocations caused by overcapacity in many critical industrial sectors. Otherwise market economy producers will respond to the market signals flowing from the excess capacity that prices are unsustainable by closing plants, writing off assets and laying off workers even if the plants being closed are in fact internationally competitive.[3] For example, in the aluminum sector, western aluminum producers have been closing aluminum smelters in many parts of the world because of the depressed prices caused in large part by China's massive excess capacity and inventories of product overhanging the market. In the US, six aluminum smelters have closed or been announced as closing in the last six months, leaving the US with a capacity back at 1950s levels. Yet China has no natural competitive advantage in the production of aluminum and environmentally its production is not desirable being largely coal-powered for energy. Nonetheless, China has expanded its aluminum capacity from 1.75 million tons in 1996 to an estimated 36 million tons in 2015.[4] And in 2014 alone, Chinese excess capacity was estimated at more than 10 million tons.[5] China now accounts for more than half of the world's aluminum smelting capacity (52.3% vs. 7.9% in 1996).[6] Meanwhile, US capacity has

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[3] The US Trade Representative's Office, in its December 2015 Report on China, summarized the problem of excess capacity:

> Excess Capacity
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> Chinese government actions and financial support in manufacturing industries like steel and aluminum have contributed to massive excess capacity in China, with the resulting over-production distorting global markets and hurting U.S. producers and workers in both the United States and third country markets such as Canada and Mexico. While China recognizes the severe excess capacity problem in the steel and aluminum industries, among others, and has taken steps to try to address this problem, there have been mixed results.
>
> From 2000 to 2014, China accounted for more than 75 percent of global steelmaking capacity growth. Currently, China's capacity alone exceeds the combined steelmaking capacity of the European Union (EU), Japan, the United States, and Russia. China has no comparative advantage with regard to the energy and raw material inputs that make up the majority of costs for steelmaking, yet China's capacity has continued to grow exponentially and is estimated to have exceeded 1.4 billion metric tons (MT) in 2014, despite weakening demand domestically and abroad. While China's steel production is slowing and China may produce approximately 2 to 3 percent less steel in 2015 than in 2014, steel demand in China is projected to decrease 5 percent this year. As a result, China's steel exports grew to be the largest in the world, at 93 million MT in 2014, a 50-percent increase over 2013 levels, despite sluggish steel demand abroad. In 2015, there is rising concern that China's steel exports are still growing and may have increased 25 percent in the first ten months of 2015, as compared to the same period in 2014.
>
> Similarly, monthly production of aluminum in China doubled between January 2011 and July 2015 and continues to grow. Large new facilities are being built with government support, including through energy subsidies. China's aluminum excess capacity is contributing to a severe decline in global aluminum prices, harming U.S. plants and workers.
>
> Excess capacity in China – whether in the steel industry or other industries like aluminum – hurts U.S. industries and workers not only because of direct exports from China to the United States, but because lower global prices and a glut of supply make it difficult for even the most competitive producers to remain viable. Domestic industries in many of China's trading partners have continued to respond to the effects of the trade-distortive effects of China's excess capacity by petitioning their governments to impose trade remedies such as antidumping and countervailing duties.

2015 USTR Report to Congress on China's WTO Compliance (December 2015) at 12-13, https://ustr.gov/sites/default/files/2015-Report-to-Congress-China-WTO-Compliance.pdf.

[4] U.S. Geological Survey, *Mineral Commodity Summaries, 1998 and 2016*, http://minerals.er.usgs.gov/minerals/pubs/commodity/aluminum/050398.pdf; http://minerals.usgs.gov/minerals/pubs/commodity/aluminum/mcs-2016-alumi.pdf. *See also* Attachment 2 (chart and table showing China's aluminum capacity).

[5] U.S. Geological Survey, *Mineral Commodity Summaries, 2016*, http://minerals.usgs.gov/minerals/pubs/commodity/aluminum/mcs-2016-alumi.pdf.

[6] U.S. Geological Survey, *Mineral Commodity Summaries, 1998 and 2016*,

declined by 52 percent from 4.2 million tons in 1996 to 2 million tons in 2015 and will be much smaller in 2016 following the announced closures or planned closures of six smelters since September 2015 (one million tons).[7] Thousands of aluminum workers in the US have lost or are losing their jobs. America now has less than 3 percent of the world's primary aluminum production capacity and will have less than 2 percent in 2016.[8]

The global steel sector is also in crisis.[9] China's steel capacity has skyrocketed from 145 million tons in 2000 to more than 1 billion tons today (some estimates are as high as 1.4 billion tons) with excess capacity of as much as 40% – equal to the total capacity in the US, EU and Japan.[10] The problem of excess capacity in the steel sector has been studied for a number of years within the OECD,[11] has been the subject of bilateral discussion between the US and China[12] as well as the EU and China. Over the past few years, the Chinese have announced a series of production cuts with little or no actual net reductions in steel capacity to date. The government of China has announced in recent weeks a program to close 100-150 million tons of capacity in the steel sector over the next five years[13] – a huge sum of capacity if actually achieved but as little as one fourth of what is needed in fact.

Companies harmed by globally depressed prices and rising import levels can seek relief through trade remedies.[14] However, for products like aluminum or steel, problems often reflect loss of export markets (China or third country) as well as loss of one's home market. Trade remedies are generally available for import problems. WTO cases can be brought for loss of third country markets or loss of the market by the subsidizing country but require the willingness of the home government to bring such a case. However, existing WTO rules do not provide members with quick and effective means to address excess capacity.

> The WTO has fairly limited tools to address these types of problems in large part because the problem is less common where economies work on market principles and hence large scale excess capacity is unusual (outside of a deep recession). While China has many

http://minerals.er.usgs.gov/minerals/pubs/commodity/aluminum/050398.pdf; http://minerals.usgs.gov/minerals/pubs/commodity/aluminum/mcs-2016-alumi.pdf.

7 *Id.*

8 U.S. Geological Survey, *Mineral Commodity Summaries*, 2016, http://minerals.usgs.gov/minerals/pubs/commodity/aluminum/mcs-2016-alumi.pdf.

9 *See generally, Surging Steel Imports Put Up To Half A Million U.S. Jobs At Risk,* Terence P. Stewart, Elizabeth J. Drake, Stephanie M. Bell, and Jessica Wang (Stewart and Stewart), and Robert E. Scott (The Economic Policy Institute), http://www.epi.org/publication/surging-steel-imports/#iv.-the-future-of-the-domestic-steel-industry-depends-on-effective-trade-remedy-enforcement.

10 *See* Attachment 2 (chart and table showing China's steel capacity). *See also* *Developments in Steelmaking Capacity of Non-OECD Economies*, http://www.oecd-ilibrary.org/industry-and-services/developments-in-steelmaking-capacity-of-non-oecd-countries_19991606; *China's excess crude steel still a problem*, http://asia.nikkei.com/Politics-Economy/Economy/China-s-excess-crude-steel-still-a-problem.

11 *See, e.g.,* OECD, *Steelmaking Capacity*, http://www.oecd.org/sti/ind/steelcapacity.htm.

12 The United States and China engaged in discussions regarding excess capacity in the steel sector at the SE&D meeting in July 2014 and regarding the steel and aluminum sectors at the JCCT meeting in November 2015. *See* USTR December 2015 Report on China, at 104-105, https://ustr.gov/sites/default/files/2015-Report-to-Congress-China-WTO-Compliance.pdf.

13 *China to cut steel capacity by 100-150 mln tonnes in 5 years*, http://news.xinhuanet.com/english/2016-02/04/c_135075575.htm.

14 *Pain Spreads From China's Excess Production*, http://blogs.wsj.com/chinarealtime/2014/07/16/pain-spreads-from-chinas-excess-production/ (noting that "China's vast excess capacity makes it the biggest target of [trade] sanctions").

> practices which warrant WTO challenges and the massive level of government subsidies likely would permit a successful challenge for serious prejudice[15] to the interests of many trading partners in these sectors, governments have a limited capacity to bring such challenges and, as shown by the serious delay in completing disputes in recent years, the WTO has an even lower capacity to handle a large number of disputes. WTO challenges at best are longer term in time frame – meaning a great deal of damage will be done to trading partners, to their companies, workers and communities before any resolution is possible.[16]

Even where the problem is primarily an import problem, the remedy is not necessarily simple or limited to the country which has created the problem. Excess capacity affects producers around the world, often creating a domino effect where loss of home market by producers in one market result in those producers increasing their exports to other countries trying to maintain their operations. Also, because trade remedies such as antidumping or countervailing duty measures are product- and country-specific, these "traditional trade remedies are micro-tools in nature and can at best protect individual home markets, often requiring several rounds of cases on the same product in a given country where serious excess capacity remains in play and exports shift from one market to another as cases close off particular markets."[17] The result is that the number of cases that need to be brought and the potential multiple rounds of cases complicate efforts to address problems in the home market.

It is very clear that there has been an explosion of steel trade remedy cases around the world – antidumping, countervailing duty and/or safeguard actions – in the last several years. In the US there have been a large number of trade remedy cases filed (various flat rolled products and various pipe and tube products, usually each set of cases going after 5-7 countries under the AD and/or CVD laws).[18] And many other WTO members have similarly brought groups of cases in an effort to deal with depressed steel prices, closing mills and loss of jobs. For example, between January 1995 and June 2014, 1,022 antidumping initiations concerning steel and other products were brought against China of which 740 resulted in antidumping duties.[19]

Since the first countervailing duty cases were launched against China, to counter its large number of government subsidies, in 2004, more CVD cases have been brought against China than any

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[15] The WTO Agreement on Subsidies and Countervailing Measures ("SCM Agreement"), Article 5, provides: "No Member should cause, through the use of any subsidy … adverse effects to the interests of other Members, i.e.: (a) injury to the domestic industry of another Member; (b) nullification or impairment of benefits accruing directly or indirectly to other Members under GATT 1994 in particular the benefits of concessions bound under Article II of GATT 1994; (c) serious prejudice to the interests of another Member."

[16] Terence P. Stewart, *Global Crisis in Steel and Aluminum Flowing from Chinese Excess Capacity; More to Come* (November 23, 2015), http://www.stewartlaw.com/Article/ViewArticle/1050.

[17] Terence P. Stewart, *Global Crisis in Steel and Aluminum Flowing from Chinese Excess Capacity; More to Come* (November 23, 2015), http://www.stewartlaw.com/Article/ViewArticle/1050.

[18] *See, e.g.,* AISI, *Comments Concerning China's WTO Compliance* (September 23, 2015) at Appendix I (listing 19 antidumping orders and 14 countervailing duty orders imposed by the US on imports of steel products from China), https://www.steel.org/~/media/Files/AISI/Public%20Policy/Letters/AISI-Comments-Regarding-China-WTO-Compliance-092315.pdf.

[19] *See China's Excess Capacity: Drivers and Implications*, Rui Fan, Trade Consultant, Stewart and Stewart (June 2015); http://www.stewartlaw.com/Content/Documents/China's%20Excess%20Capacity%20-%20Drivers%20and%20Implications.pdf.

other country (84 initiations; 53 measures).[20]

In sectoral terms, more than 80% of the world's antidumping and countervailing duty cases against China have been concentrated in six industries: base metal, chemical, machinery and equipment, textile, rubber and plastics and stone, cement, and glass.[21]

The base metal sector, including steel, copper, and aluminum, accounted for more than a quarter of the antidumping cases and over half of the countervailing duty cases.[22] Thus, it is evident that the Chinese industries with excess capacity are the ones most often subject to trade remedy investigations. As must be clear, the time needed to pursue solutions, however short, ensures that some part of the "correction" in the market will occur in markets that have not contributed to the problem. That has already happened as the closure of various aluminum smelters[23] and steel mills in the US and elsewhere attests. The longer the time needed and the slower the implementation of correction in the causing market – here China – the more of the correction that will necessarily occur elsewhere. In the meantime, the sectors and their workers will be in crisis.

I have included a paper, "China's Excess Capacity: Drivers and Implications" by Rui Fan, a trade consultant at Stewart and Stewart, as a supporting document to this testimony.[24] The paper is an updated version of a paper released last summer, which looks at causes, sectors affected and actions being taken by the Chinese government to address the problem of excess capacity in China. The enclosed paper also includes an addendum to address a number of the questions this panel was asked to consider. I am also attaching several charts which look at capacity (global and in China) and production for steel and aluminum reported in particular sources showing developments over the last 15-20 years.

In conclusion, I recognize that some progress is being made in addressing the Chinese overcapacity crisis. I recognize and commend the Obama Administration for being presently engaged in discussions with China on the steel and aluminum sectors. It is also evident that China recognizes the seriousness of the problem and has taken some steps to address the problem including its recent pronouncements in the steel sector. But the progress is much too slow -- meaning communities, workers and communities across the United States and much of the rest of the world are paying the price of the Chinese economic model and its massive subsidization of capacity additions across a wide array of manufacturing sectors. While some industries have pursued trade remedy relief to deal with the harm caused, the nature of trade remedies usually means significant harm has already occurred – plants have closed, workers have lost jobs, communities are seriously affected. Much more needs to be done now by China and, if necessary, by its trading partners.

Some broader and perhaps more effective actions to address the ongoing crisis in key U.S. industries should also be considered. Among the ideas which should be on the table are:

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[20] *Id.*

[21] *Id.*

[22] *Id.*

[23] "Since September 2015, six primary aluminum smelters in the United States have shut down, or have announced plans to shut down, 1.08 million metric tons per year of capacity. (See Aluminum in July 2015, August 2015, September 2015, and October 2015.)" U.S. Geological Survey, *Mineral Industry Surveys*, November 2015 at 1, http://minerals.usgs.gov/minerals/pubs/commodity/aluminum/mis-201511-alumi.pdf. The months cited (July-Oct. 2015) are available at http://minerals.usgs.gov/minerals/pubs/commodity/aluminum/mis-201507-alumi.pdf; http://minerals.usgs.gov/minerals/pubs/commodity/aluminum/mis-201508-alumi.pdf; http://minerals.usgs.gov/minerals/pubs/commodity/aluminum/mis-201509-alumi.pdf; http://minerals.usgs.gov/minerals/pubs/commodity/aluminum/mis-201510-alumi.pdf.

[24] Paper included in Panel III readings.

(1) The ITC *sua sponte* or Congress through amendment could recognize threat of material injury in any sector where there is global excess capacity of a significant magnitude and global prices have declined below full cost of production.

(2) The US and major trading partners could encourage China to seek a waiver[25] at the WTO of obligations on export taxes not permitted by its Protocol of Accession and then apply high export taxes on all products in sectors (not just upstream products but downstream products as well) where China has excess capacity until such time that global supply and demand are back in balance.

(3) The US and major trading partners could seek a waiver[26] to permit imposition of quotas or above bound tariff rates on products where there is massive global excess capacity until such time as China's program of eliminating excess capacity has in fact been effective and balance between global supply and demand has been restored.

(4) The US and major trading partners could seek consultations with China in the WTO on the serious prejudice and other violations of WTO obligations created by the massive subsidies and other practices that have created the excess capacities that have reduced access to the Chinese market, caused loss of market share in third countries, loss of market share at home or where China has increased its share of global trade above where it would have been.

(5) For selected industries, the Administration could pursue action under Section 232 of the Trade Expansion Act of 1962 (national security).[27]

(6) The Administration (Department of Commerce) should issue guidance that in considering whether a country that is currently treated as a non-market economy should be treated as a market economy country under US antidumping law, one of the important "other factors" Commerce will consider is whether the policies of a country have created significant excess capacity that has not been eliminated at the time of the consideration of status of the country. 19 U.S.C. § 1677(18)(B)(vi).

(7) Longer term, through FTAs or the WTO, the US and trading partners could seek agreed rules to prevent the build-up of significant excess capacity in industries and steps that can be taken to address such situations promptly if they do occur.

Finally and perhaps most immediately, the Obama Administration could self-initiate trade cases under Title VII of the Tariff Act of 1930 (antidumping and countervailing duty laws) on a broad basis and/or request the initiation of safeguard actions as the Bush Administration did in 2001 in

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[25] Article IX:3 of the WTO Agreement provides that "the Ministerial Conference may decide to waive an obligation imposed on a Member by this Agreement or any of the Multilateral Trade Agreements, provided that any such decision shall be taken by three fourths of the Members." Examples of waivers include the TRIPS waiver on access to essential medicines, waivers on trade preferences for developing countries, and the Kimberley waiver on conflict diamonds. A list of WTO waivers granted is available at https://www.wto.org/english/res_e/booksp_e/analytic_index_e/wto_agree_04_e.htm#tableD.

[26] *Id.*

[27] 19 U.S.C. § 1862. The purpose of a Section 232 investigation is to determine the effect of imports on the national security. Investigations may be initiated based on an application from an interested party, a request from the head of any department or agency, or may be self-initiated by the Secretary of Commerce. *See* https://www.bis.doc.gov/index.php/other-areas/office-of-technology-evaluation-ote/section-232-investigations.

steel. Companies and workers have been bringing many cases but, in some sectors, cases may be practically not possible because of retaliation concerns in China or the fragmented nature of the industry or the industry's financial condition.

What is clear is that the world faces serious economic challenges in many manufacturing sectors flowing from state activism by China that has created excess capacities in a host of industries. The size of the excess capacities in many industries has never been seen before and could not have happened under market economy conditions. US companies and workers as well as companies and workers in many other countries have already paid a price for this massive imbalance. Concerted efforts by China and its trading partners to address this disequilibrium within China are necessary now. Otherwise, balance will not be restored for many years, with massive job losses and destruction of much of the manufacturing infrastructure of the United States and elsewhere the result. Clearly, the stakes are high both for the future of manufacturing in America and for the global economy. We must put concerted pressure on China to act as it has realized it must but to do so on a timeframe and a scale that is meaningful to its trading partners and that results in a restoration of balance in global supply and demand.

OPENING STATEMENT OF MR. JEREMY HAFT
COFOUNDER AND PARTNER, CARACAL STRATEGIES
CEO, SAFE SOURCE TRADING

MR. HAFT: Thank you, Chairman Shea, Vice Chairman Bartholomew--

MS. McLAUGHLIN: Microphone please. Push the button.

MR. HAFT: I press--oh, there you go. Okay. Thank you. And I yield back the balance of my time.

[Laughter.]

MR. HAFT: Chairman Shea, Vice Chair Bartholomew, Co-chairs Cleveland and Wessel, thank you very much for inviting me to testify before you today, and I appreciate the opportunity to discuss Chinese overcapacity. I'll focus my remarks on what this phenomenon looks like from the ground up, from factories in China and farms, and how overcapacity poses a challenge to American firms but also significant job-creating opportunities.

There's no doubt that overcapacity in many of China's industries is a vexing challenge for China's trading partners, but when comparing China and the United States, it's important to remember that capacity is not the same thing as capability.

Americans tend to imagine that there is parity between American and Chinese industrial capability, and that a pound of Chinese steel is equal in quality to a pound of American steel. So considered in that context, China's industrial overcapacity would follow the laws of supply and demand: the more supply there is, the less demand there is. But viewed from the ground, the opposite is true. In China, it's possible to have an abundance of supply and an abundance of demand and the reason lies in the very way that China makes things, the structure of its industries.

Consider for a moment the output of China's manufacturing and agricultural sectors. There have been thousands of safety breaches just in the past few years and tens of thousands in the past decade. In every corner of China's economy, severe safety lapses are a daily fixture of China's life, and it's not a matter of a few bad actors as the authorities would have us believe. The whole system is to blame.

China's manufacturing and agricultural sectors are hamstrung by structural risk. So as products are transformed from raw materials to finished goods, they move through concentric circles of danger, from unsafe raw material inputs to firms with weak corporate governance, aligned in long opaque supply chains that are overseen by ineffective government regulators that are often warring with one another.

So each step of the production process adds risk that the finished goods will be unsafe. Now that presents a threat to our health and safety because our inspectors screen a very tiny fraction of imports, but it also presents job opportunities because as China struggles to make safe goods, its consumers and businesses clamor for American-made products which are considered safe and high quality in comparison.

So China's steel industry is a good example of this dynamic. On the risk side, consider the San Francisco Bay Bridge where the renovation of the eastern and western spans has been plagued with unsafe Chinese steel fabrication. As soon as the project began, U.S. inspectors discovered that 65 percent of the panels had defective welds. The inspection firm was ultimately replaced, and the welding tolerances were loosened.

And in offshore drilling that was considered the most technologically advanced shipbuilding enterprise in China, SWS flunked Shell's audit across every evaluation category, and they were disqualified from the project.

So the tens of thousands of safety breaches emerging from China's industries are a key driver of demand for U.S. goods and services.

42 states at least doubled their exports to China since 2005. Five of them increased their exports by more than 500 percent. Ohio more than tripled its exports, and Michigan quintupled them, and over the same period of time, exports to China from 92 percent of all congressional districts have at least doubled.

Now most of our top non-agricultural goods exports to China are downstream steel industries: aircraft and parts; machinery; passenger vehicles; and electronics. These exports have continued to grow over the past decade despite overcapacity in China's steel industry. So even as China's economy slows, its high savings rate will ensure it will keep buying goods and services that are considered essential, safe and of high value, especially those which China struggles to produce itself.

Now, of course, this does not negate the fact that China's overcapacity continues to lead to dumping, but the unintentional side effect of raising import duties is that we may protect some jobs at the expense of other jobs. That's because most of the products we import from China include U.S. value add at multiple points in the supply chain. The solar industry is a good example of this where the U.S. is actually a net exporter to China.

Our top solar export to China is the capital equipment and our second top export is the PV polysilicon, and when we raised duties on imported Chinese solar panels, China retaliated by imposing a 57 percent duty on imported American polysilicon, and as a result, REC Silicon, a major global supplier, just suspended operations at its 550-acre facility in Washington state because of sluggish exports to China. So we ought to consider other remedies to dumping. First, we could wield our leverage as China's largest importer to enact stricter safeguards to protect ourselves from unsafe Chinese imports, not just cheap Chinese imports.

Currently, U.S. inspectors are barred from many of the Chinese firms that supply products to our markets. And it's relatively easy for a Chinese firm to qualify for sales to the United States. That needs to change. We need to adopt a much more comprehensive inspection and supplier certification system, and that would not only help protect our health and safety, it would also add the financial costs of strict quality control into the total delivered price of Chinese imports.

Now, both the JCCT and the S&ED are venues in which these issues could be raised and given top priority.

Second, we could fight the illegal subsidies that prop up Chinese industries with overcapacity more aggressively in the WTO.

And third, let's remember that China will chair the G20 this year. The U.S. should use that forum to work aggressively to ensure that China's commitments are fulfilled.

And finally, a good defense against Chinese dumping is a good offense, or put another way, as the old saying goes, the best revenge on a lousy customer is to sell him more goods.

Although U.S. exports to China are growing, our export intensity remains rather low, and there's a lot more we could be selling to China in just about every industry. Certainly, market access is an issue, but nothing is monolithic in China, and that includes access. Access often depends on who's buying. And although indigenous innovation and procurement laws are making it relatively harder for some U.S. firms to operate in China, that does not dispel the basic economic dynamic of China's need for what America makes.

For example, even though top tier Chinese hospitals are now required to buy Chinese-made medical equipment, industry insiders will tell you that Chinese hospitals promptly mothball this equipment in favor of American-made products which are seen to be more advanced and more reliable.

It's no accident that American exports to China over the past decade have grown faster than to any part of the world no matter what China's currency exchange rate might be or its varying levels of capacity. China's needs are driven by demand, scarcity and risk. And that plays perfectly to America's abiding competitive strengths.

Thank you.

PREPARED STATEMENT OF MR. JEREMY HAFT
COFOUNDER AND PARTNER, CARACAL STRATEGIES
CEO, SAFE SOURCE TRADING

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

China's Shifting Economic Realities and

Implications for the United States

February 24, 2016

Jeremy R. Haft

Chairman Shea, Vice Chairman Bartholomew, and members of the U.S.-China Economic and Security Review Commission, thank you very much for inviting me to testify before you today. I appreciate the opportunity to discuss China's economy and the issue of overcapacity. I'd like to focus my remarks on what this phenomenon looks like from the ground up, and how overcapacity poses a challenge to American firms, but also significant job-creating opportunities.

My view of China's economy is from the perspective of factories and farms. I started my first sourcing company in China in 1998 with one of the lead Tiananmen Square dissidents, beginning with a door-to-door investigation of China's supply chain, in which our team visited over 800 firms, inspecting plant and equipment and interviewing line employees and managers. Since then, we've gone on to make (or try to make) dozens of different light and heavy industrial goods in China for U.S. clients – from chum buckets to offshore drilling rigs – and today are exporting American agriculture to China, such as pork and cattle hides.

There is no doubt that overcapacity in many of China's industries is a vexing challenge for China's trading partners. When a pound of Chinese steel costs about as much as a pound of cabbage in local markets, it doesn't take a huge leap of logic to understand why a Chinese mill would try to export that steel, especially when there are willing buyers and often a Value Added Tax rebate from the Chinese government to sweeten the deal.

It's also true that for years, Beijing has made many commitments to curb capacity that have gone unfulfilled. So the latest pronouncements by China's State Council to cut over 100 million tons of capacity in the next five years must be taken with a whole shaker of salt. True, the recent commitment to create a fund to offset the costs of Chinese unemployment due to plant closures is a positive development. But it still remains unclear whether China's central government can enforce these promised cuts, as provincial and municipal governments are vested with the authority to protect local firms.

China's overcapacity issue, therefore, is a multi-dimensional problem that will require difficult, far-reaching political choices by the Chinese leadership amidst a slowing economy, which is a primary reason why we won't see a quick or easy resolution. And that is also why it is important to examine the nature of overcapacity in China's industries, as there are some positive implications for the U.S. economy that are frequently overlooked.

What Chinese Overcapacity Really Means

When comparing China and the United States, it is important to remember that capacity is not equivalent to capability. Americans tend to imagine that there is parity between American and Chinese industrial capability. That a pound of Chinese steel is equal in quality to a pound of American steel. Considered in that context, China's industrial overcapacity would follow the laws of supply and demand. The more supply there is, the less demand.

But viewed from the ground, the opposite is true. In China, it is possible to have an abundance of supply *and* an abundance of demand. The reason lies in the way that China makes things – the structure of its industries and the human resources that make up its companies. Consider, for a moment, the output of China's manufacturing and agricultural sectors. There have been thousands of safety breaches just in the past few years and tens of thousands in the past decade. August's giant explosion in Tianjin, for example, was just one of more than 300 major industrial accidents in the seven months that preceded it. Poisoned baby formula, lethal pharmaceuticals, cadmium-heavy rice, lead-coated toys, collapsing bridges, toppling buildings – in every corner of China's economy, severe safety lapses are a daily fixture of Chinese life. A popular Chinese news anchor, Qiu Qiming, put it best when he said on national television, "Can we drink a glass of milk that is safe? Can we stay in an apartment that will not fall apart? Can we travel roads in our cities that will not collapse?" [1]

It's not a matter of a few bad actors, as the authorities would have us believe. The whole system is to blame. China's manufacturing and agricultural sectors are hamstrung by structural risk. As products are transformed from raw materials to finished goods, they move through concentric circles of danger: from unsafe raw material inputs to firms with weak corporate governance aligned in long, opaque supply chains that are overseen by ineffective, often warring, government regulators. Each step of the production process adds risk that the finished products will be unsafe.

Systemic risk in China's value chain presents a significant threat to our health and safety, as U.S. inspectors screen only a tiny fraction of imports. We've already experienced firsthand the danger of "Made in China" products with lethal blood thinner, faulty auto ignitions, toxic drywall, deadly pet food, lead coated toys, and defective accelerator pedals, to mention just a few of a myriad examples.

But systemic risk also presents opportunities. Because as China struggles to make safe goods, its consumers and businesses clamor for American made products, which are considered safe and high quality. So even though some Chinese industries are glutted with overcapacity, since there is such a wide gap in capability, an abundance of demand co-exists with an abundance of supply.

[1] Evan Osnos 2012, *Boss Rail: The Disaster That Exposed The Underside of The Boom*, The New Yorker, http://www.newyorker.com/magazine/2012/10/22/boss-rail

Risk in China's Steel Industry

As an example of this phenomenon, I'd like to focus on China's steel industry, which suffers from severe overcapacity. Chinese steel is infamous for its relatively low quality. Part of the problem begins upstream with inferior inputs. In steel production, iron ore is mined from the ground and then processed to make different grades of steel for different industrial purposes. Higher quality steel requires higher iron content. However, the iron content in China's mined ore tends to be quite low. That's the reason why China imports over half of the iron ore it uses to make steel.

However, it's very difficult to detect when low quality iron ore is used as an input to steelmaking because China's steel industry, just like all of China's industries, consists of long, fragmented supply chains inhabited mostly by weakly governed firms – susceptible to fraud and/or slipshod quality control. It is estimated that there are over 1,200 steel producers in China – more than ten times as many than in the United States – and just 70 are thought to be large or medium sized. [2] Trying to trace the quality of inputs through this thicket is nearly impossible. Charles Bradford, president of Bradford Research, a metals consultancy, put it this way: "Most of China's…steelmakers are small fabricators who have no idea what quality is about, so there is a risk that guy with a welding torch buys some hot-rolled coil steel and just welds it together." [3]

In 2007, American and Canadian institutes of steel construction warned member companies to be especially cautious with Chinese "high-strength" steel inputs. When tons of the Chinese steel were tested, "the welds failed horribly," said Dan Malone, construction manager for Garneau Manufacturing. [4] Malone added that had the steel been processed into a finished product, "it would have killed somebody."

The world got a glimpse of Chinese-made steel in action during the 2008 earthquake in Sichuan. Compared to buildings and bridges in California, many of which were built several decades ago but have been able to withstand earthquakes of much stronger magnitude, thousands of Chinese-made buildings collapsed like houses of cards – especially school buildings. Inferior raw materials could have been a cause, but the fact that schools, even ones that were recently built, toppled while older buildings remained intact, revealed the potential for fraud, and there was a public outcry that the Ministry of Education had cut corners in construction.

Cutting corners to save money is a common technique in China's construction boom, as low cost building puts pressure on developers' margins. Since the Sichuan earthquake, the widespread practice of "steel thinning" in China has come to light, in which regulation thickness reinforcing bars are stretched to a thinner specification and sold for cheaper prices. Thinning steel is one way builders can claw back profit while appearing to abide by architectural specifications. [5]

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[2] Rachel Tang 2010, *China's Steel Industry and Its Impact on the United States: Issues for Congress*, Congressional Research Service, https://www.fas.org/sgp/crs/row/R41421.pdf
[3] Ibid.
[4] Jim Ostroff 2007, *New Threat From China: Shoddy Steel Imports*, Kiplinger, http://marcchamot.blogspot.com/2008/05/china-earthquake-reveals-new-threat.html
[5] Leo Lewis 2011, *China Troubled By Steel-Thinning Scam In Building Foundations*, The Times, http://www.theaustralian.com.au/archive/business/china-troubled-by-steel-thinning-scam-in-building-foundations/story-e6frg90o-1226136555319?nk=4621bbab429baf4d90d069b2ec77850a

Residents of China's cities are familiar with the effects of slipshod building techniques, having to evade the frequent "glass bombs," in which windows from modern skyscrapers come lose and plummet to the sidewalk.

It would be convenient to blame fraudulent or negligent quality control in Chinese construction on its thousands of small to midsized steel fabricators. But several recent case studies show how large state-owned enterprises that deploy advanced technologies also produce low quality, dangerous outputs.

Consider the San Francisco Bay Bridge, where the renovation of the eastern and western spans has been plagued with unsafe Chinese steel fabrication. At a projected cost of $6.4 billion, the California Transportation Authority ("Caltrans") presumed that they would save about $400 million on the job by sourcing steel from China. [6] Of course, they weren't factoring in cost overruns from quality lapses, which caused the project to go billions of dollars over budget and was ten years late.

China's Zhenhua Port Machinery Company ("ZPMC"), a world leader in making cranes, was hired to fabricate 900 panels to be assembled into football field long deck plates. Caltrans justified their choice of ZPMC because of its giant 1.2 square mile fabrication facility created specifically for the project that featured modern technology and legions of engineers and linemen, who were tasked to work day and night.

As soon as ZPMC started production, however, the on-site U.S. inspection team discovered that 65% of the panels had defective welds. [7] The inspectors noted that ZPMC "failed to provide most of the quality control documentation required under its contract…and had failed to produce a single test weld that conformed to the contract specifications." [8] Shortly thereafter, the inspectors warned of "random weld quality" on more than 100 panels and urged the production process stop until ZPMC improved its welding. Production didn't stop, the inspection firm was replaced, and the welding tolerances loosened.

It is because of chronic quality control problems on Chinese steel in infrastructure projects around the world that some firms like Halliburton prohibit Chinese steel in many bid proposals, such as a job to build a refinery tank farm for Conoco Phillips and Saudi Aramco. Shell Oil is another global firm that is wary of Chinese steel applications. Since the establishment of Shell's China sourcing office in 2005, procurement of China content focused solely on lower value castings and fittings. But after years of requests by the China office to source higher value content, Shell offered the opportunity to build major parts of an offshore drilling rig to Shanghai Waigaoqiao Shipyard ("SWS"), the jewel of the mammoth, state-owned China State Shipbuilding Company.

Though it is considered the most technologically advanced shipbuilding enterprise in China, SWS flunked Shell's audit across every evaluation category. It lacked the ability to monitor the

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[6] David Barboza 2011, *Bridges Comes To San Francisco With A Made-In-China Label*, The New York Times, http://www.nytimes.com/2011/06/26/business/global/26bridge.html?pagewanted=all
[7] Ibid.
[8] Ibid.

quality of its suppliers and their outputs, to identify and manage hazardous and defective materials, and to conduct proper engineering and design. Perhaps most importantly, Shell found that SWS lacked basic lines of reporting and clearly defined job responsibilities, generally undermining accountability and magnifying risk. Despite having the latest technology, SWS's weak corporate governance and sloppy quality control systems led Shell to determine that China's most advanced shipyard posed a significant project risk and was disqualified from the project.

Chinese Demand for U.S. Goods and Services in the Steel Industry

The tens of thousands of safety breaches emerging from China's manufacturing and agricultural sectors over the past decade is a key driver of demand for U.S. goods and services. As China struggles to make safe goods, it must import them from advanced economies like the United States. Contrary to the popular opinion that uncompetitive America doesn't export anything, the United States is actually an exporting goliath. In 2013, the U.S. exported a record $2.3 trillion of goods and services to the world. [9] And exports made up more than 46% of the growth in America's economy from 2010 and 2011 alone – led by U.S. manufacturing. [10]

Given that China is our third largest export market, as well as our fastest growing market for many products and services, U.S. export growth, in large part, can be attributed to Chinese demand. In fact, U.S. export sales to China have tripled in one decade, rocketing China up to our third largest export market behind Mexico and Canada. This export growth is shared across the breadth of our economy – from agriculture to manufacturing to services – and across every state in the union. 42 states at least doubled their exports to China since 2005, 5 states increased their exports by more than 500%, Ohio more than tripled its exports and Michigan more than quintupled them. And, over the same period of time, exports to China from 92% of all congressional districts have at least doubled. [11]

What bears noting in our discussion today is that most of our top non-agricultural goods exports to China are downstream steel industries: aircraft and aircraft parts, machinery, passenger vehicles, and electronics. It should also be noted that our exports in these categories have continued to grow over the past decade, despite overcapacity in China's steel industry and the trend of dumping steel in the United States.

The nuclear power industry is a good example of this dynamic. China's inability to overcome risk in building and maintaining reactors has resulted in an export bonanza for the United States in N-Class steel products and services, supporting thousands of American jobs. Westinghouse and General Electric are designing the next generation of nuclear reactors being deployed in China, and American firms are manufacturing and exporting critical components for these nuclear facilities. Just four Chinese reactors under construction have created 5,000 U.S. jobs at

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[9] Office of Public Affairs 2014, United States Department of Commerce, *U.S. Exports Reach $2.3 Trillion in 2013, Set New Record for Fourth Straight Year in a Row*, https://www.commerce.gov/news/press-releases/2014/02/us-exports-reach-23-trillion-2013-set-new-record-fourth-straight-year

[10] Economic and Statistics Administration, United States Department of Commerce 2014, *The Role of Exports in the United States Economy*, http://trade.gov/neinext/role-of-exports-in-us-economy.pdf

[11] The US-China Business Council 2015, *US State Exports to China (2005-2014)*, https://www.uschina.org/reports/us-exports/national

Westinghouse and other suppliers. [12] And with more than twenty new Chinese reactors in the pipeline, companies like America's Curtiss-Wright Flow Control Company are building pumps for them that are unique in the world, as they run maintenance free for sixty years. [13] Other firms like Tyco International are also creating U.S. jobs in supplying high precision valves for Chinese nuclear reactors, each of which sells for $10-30 million, as well as the testing of those valves. Tyco recently opened a $25 million testing lab in Mansfield, Massachusetts.

China is also providing a platform for the commercialization of next generation American nuclear technology, too – especially small, modular reactors that can be deployed more nimbly than large reactors. One company in this space is TerraPower, backed by Bill Gates, which is developing the traveling wave reactor that consumes a low-grade form of uranium. This would allow countries to use nuclear power without the enrichment phase, a necessary step toward weaponization. Another American firm, Babcock and Wilcox, is pioneering the manufacture of modular reactors, which are built entirely in a U.S.-run factory, mitigating on-site construction risk.

Even as China's economy slows, the Chinese government and households have high rates of savings. And they will continue to spend money on goods and services that are considered essential, safe, and of high-value – especially those which China struggles to produce itself.

Remedies

The fact that China is importing so much from America, of course, does not negate the fact that China's overcapacity continues to lead to dumping. But the unintentional side effect of defending ourselves from dumping through raising import duties is that we may protect some jobs at the expense of others. That's because most of the products we import from China include U.S. value-add at multiple points in the supply chain. Most often, in the beginning: with invention, design, engineering, branding, and the manufacture of inputs and components. And at the end: with transportation, warehousing, wholesaling, retailing, and service. China usually occupies the middle phases, which sometimes may involve engineering and manufacturing, but usually consists of assembly.

So in trying to save American jobs through raising import duties at one node of the supply chain, *other* American jobs are adversely impacted. The solar industry is a good example of this phenomenon, where U.S. value is added at the beginning and end of the value chain. Our top solar export to China is the expensive, high-tech capital equipment used to make solar panels. Our second top export is the PV polysilicon, the raw material that goes into the crystalline silicon photovoltaics, the active element in solar panels that converts sunlight into energy. China imports these items to fabricate and assemble the panels, relatively lower value functions in the chain, and then exports the panels back to us, at which point they must be transported and warehoused, the site must be prepared, permits must be filed for, and the system must be installed and maintained. If you look at the whole value chain, therefore, the majority of the

[12] Matthew L. Wald 2011, *Nuclear Industry Thrives In The U.S., But For Export*, The New York Times, http://www.nytimes.com/2011/03/31/business/energy-environment/31NUKE.html?pagewanted=all&_r=0
[13] Matthew L. Wald 2011, *Nuclear Industry Thrives In The U.S., But For Export*, The New York Times, http://www.nytimes.com/2011/03/31/business/energy-environment/31NUKE.html?pagewanted=all&_r=0

financial value in an installed photovoltaic system flows to America. In 2010, installations of U.S. solar energy systems were valued at $6.0 billion – and 75% of that was captured by U.S. firms. [14]

However, when we raised duties on imported Chinese solar panels, China retaliated by imposing a 57% duty on imported American polysilicon. As a result, REC Silicon, a major global producer of polysilicon, announced on February 8, 2016 that it was suspending operations at the only location where it produces polysilicon for the solar industry, its 550-acre facility in Moses Lake, Washington, because of sluggish exports to China. [15]

Though defending U.S. jobs is well intentioned, the unintended consequence of harming U.S. jobs occurs when import duties are raised on one node of a global supply chain. We ought to consider other remedies that do not have the effect of picking winners and losers in the U.S. economy.

First, we could wield our leverage as China's largest importer to enact stricter safeguards to protect ourselves from unsafe Chinese imports, not just cheap Chinese imports. It's not simply a matter of increasing our inspectors in the field, although that would be a good start, as our inspectors on the ground are woefully understaffed. Rather, we need to adopt a more comprehensive inspection and certification system. Currently, U.S. inspectors are barred from many of the Chinese firms that supply products to our markets, whether food, pharmaceuticals, or manufactured goods. And it's relatively easy for a Chinese firm to qualify for sales to the United States. Even chemical companies that are not regulated by the Chinese FDA can sell active pharmaceutical ingredients into the supply chain that makes up our drug supply. That needs to change.

Japan enacted an aggressive quality control inspection system coupled with a strict supplier certification process in 2002, after detecting high concentrations of pesticides in frozen spinach. Japan operates two giant inspection clearinghouses where they randomly test batches from 10% of all the food imported from China. And Japan made it much more difficult for Chinese suppliers to qualify for export into the Japanese market. [16] Similar measures would not only help protect our health and safety, they'd also add the financial cost of strict quality control into the total delivered price of Chinese imports. Both the JCCT and S&ED are venues in which these issues could be raised and given top priority.

Second, we could fight China's illegal subsidies more aggressively in the WTO. One of the reasons why Chinese industries that suffer from overcapacity continue to go about business as usual is because they're propped up by a number of government subsidies, such as free land, energy, and raw materials; debt to equity swaps; loan forgiveness; and value-added tax rebates. China's steel industry is a prime recipient of this special treatment. By systematically and comprehensively pursuing resolutions to these subsidies through the World Trade Organization,

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[14] Ibid.

[15] Rob Hotakainen 2016, *Washington State Feeling Pain from U.S. Trade Rift with China,* McClatchy DC, http://www.mcclatchydc.com/news/nation-world/world/article59385357.html

[16] Martin Fackler 2007, *Safe Food For Japan*, The New York Times, http://www.nytimes.com/2007/10/11/business/worldbusiness/11safety.html?gwh=66DF73F918A3FE882DB47A13D07ADF1D&gwt=pay

the job-killing tit-for-tat of raising import duties can be avoided.

And third, let's remember that China will chair the G20 this year. Already topping the agenda for the discussion among finance ministers is the issue of Chinese overcapacity. China's contribution as chair should be to aggressively target curbs on overcapacity in state-owned enterprises. The United States should use that forum to work closely with our Chinese counterparts to insure that their commitments are being fulfilled.

Finally, a good defense against Chinese dumping is a good offense. Or put another way, as goes the old saying, the best revenge on a lousy customer is to sell him more goods. Although U.S. exports to China are growing (and, indeed, we are running trade surpluses in agriculture and service exports), our export intensity remains rather low. There's a lot more we could be selling to China in just about every industry.

Certainly market access is an issue, but nothing is monolithic in China, and that includes access. I have encountered varying degrees of openness and levels of import duties depending on what buyer I am selling to. American grown cherries consigned to a Chinese wholesale buyer, for example, are subject to a different tariff and import protocol than if they are sold to the commissary of a group of nuclear power facilities. Access often depends on who's buying.

And although Chinese indigenous innovation and procurement laws are making it relatively harder for some U.S. firms to operate in China, that does not dispel the basic economic dynamic of China's need for what America makes. For example, even though top tier Chinese hospitals are now required to buy Chinese made medical equipment, industry insiders will tell you that Chinese hospitals dutifully buy the domestic made content, then promptly mothball this equipment in favor of American made products, which are seen as more advanced and reliable.

American companies large and small need to better understand the structural weaknesses of China's economy – how systemic risk afflicts its manufacturing and agricultural sectors – and the implications on American competitiveness. It is no accident that American exports to China over the past decade have grown faster than to any part of the world – no matter what China's currency exchange rate might be or its varying levels of capacity. China's needs are driven by demand, scarcity, and risk. That plays perfectly to America's abiding competitive strengths.

OPENING STATEMENT OF MR. JOHN FERRIOLA
CEO, NUCOR

MR. FERRIOLA: Thank you, Co-Chairs Cleveland and Wessel, and members of the Commission, for the opportunity to speak with you today.

I'm John Ferriola, Chairman, Chief Executive Officer and President of Nucor Corporation. We are the largest steel producer and the largest recycler in North America.

At Nucor, we employ about 23,000 hardworking Americans at approximately 200 locations throughout the U.S., Canada, and a few in Mexico. I'd also like to recognize Senator Dorgan, who I understand is new to the Commission. My predecessor, Dan DiMicco, who I heard you speak of earlier, was pleased to work closely with you on legislation supporting American manufacturing, and we appreciate your support and continued leadership.

Global steel production overcapacity has been a problem for a long time, but today it is a crisis. Overcapacity has led to a significant increase in unfairly traded imports entering our market, stealing recent demand growth from steel mills that are more efficient, safer, and more environmentally friendly than those in China.

Last year, finished steel imports accounted for a record 29 percent of the market share, meaning approximately one out of every three tons of steel consumed in the United States came from imports. And this led to a dramatic drop in capacity utilization at U.S. mills, sometimes down to as low as 60 percent capacity utilization.

China is the main driver of production overcapacity. The speed and scale in which the steel industry in China grew in the last 15 years is just unprecedented. In the year 2000, China produced about 100 million tons of steel, which is roughly the same as the U.S. produces today. 15 years later, their production capacity grew from 100 million tons to 1.2 billion tons. Today, China's capacity overwhelms the world.

Just how bad is the overcapacity problem? It's estimated that global steel production overcapacity in 2014 was more than 700 million tons. Remember, the U.S. steel market is about 100 million tons, so there is seven times more capacity in the world than we consume in a year in the United States.

And of that 700 million tons of excess capacity, 425 million tons comes from China alone. China's massive build-up of steelmaking capacity was not driven by market forces but instead by excessive government intervention in the market. The Chinese government literally owns most of the steel industry and is subsidizing it in many, many ways. At the same time, it limits foreign ownership of steel companies, restricts some raw material exports, and imposes huge import barriers.

Additionally, China manipulates its currency in order to drive exports of all manufactured goods. Simply put, the Chinese government is a company disguised as a country waging economic war and, frankly, winning it. I want to repeat that. Given the actions of the Chinese government, the Chinese government acts as a company disguised as a country engaged in economic warfare.

Last year, China exported more steel than that produced by all three countries in NAFTA. Chinese exports are flooding every market around the world, creating a domino effect of trade flows. Much of the world's steel ends up here because we have the most open market in the world and because other countries are much more aggressive in putting in safeguards and tariffs to ensure that their steel industries get to compete on a level playing field.

Steel companies in countries that play by the rules are paying the price for overcapacity. While foreign governments prop up inefficient steelmakers, lower-cost, safer, more efficient producers in market economies end up shutting down. That is not how a functioning market economy is meant to work.

This market distorting behavior is creating real harm for American steel workers and communities. Our teammates' pay is tied directly to the number of quality tons safely produced. When unfairly traded imports capture greater and greater market share, they're literally taking money out of our teammates' pockets.

More broadly, although Nucor does not lay off teammates, it is estimated throughout the United States steel community today, there are approximately 12,000 teammates out of work.

Let me give you a concrete example of how global overcapacity impacts our communities. In 2014, Nucor purchased Gallatin Steel and brought it into the Nucor family. Gallatin Steel is a flat-rolled mill operating in Kentucky. The Gallatin County School District receives tax revenue based upon Nucor's energy consumption. Due to the flood of unfairly traded imports, operating rates at this mill have dropped sharply--30 to 40 percent--and as a direct result, the school district faced a $500,000 shortfall in tax revenue last year.

Whether it's reduced paychecks for teammates, because we're making less steel, or less money to educate the children in Gallatin County, Kentucky, the impact of overcapacity reaches all communities across the United States.

Fortunately, there's a growing international consensus that urgent action is needed to tackle this overcapacity crisis. Last year, the OECD Steel Committee warned that--and I'm quoting here--"a failure to address or halt market distortions will result in subsidized and state supported enterprises surviving at the expense of private and efficient companies operating in environments with minimal government support."

In my view, there must be cooperation from all major steel producing countries and a commitment of governments to get out of the steel business. No ownership, no control, no subsidies. The upcoming OECD High-Level Meeting in April and the ongoing cooperation among the NAFTA governments are steps in the right direction, but more must be done. Unless China deals with its state-sponsored overcapacity, no solution will be effective.

China recently claimed that it will cut capacity by 100 to 150 million tons. However, it has failed to specify a time frame or a plan to achieve these deductions. Based upon past performance and behavior, we are dubious that anything will be done. In fact, the exact opposite may occur as recent reports suggest that Chinese state-owned enterprises are buying and restarting money-losing capacity in China today.

Without meaningful trade relief as a hammer, China will always prioritize its internal need to maintain employment and Communist Party control. The U.S. and its trading partners should accept nothing less than these reductions and more. China should provide a specific capacity reduction plan, and we should strictly verify those reductions.

In closing, immediate steps need to be taken to remove inefficient excess capacity from the market. Foreign governments must step aside and allow market forces to operate. If not, our country's steel industry and the more than one million jobs that it supports will continue to disappear before our eyes.

Thank you for your attention. I apologize for going over my time allotment.

PREPARED STATEMENT OF MR. JOHN FERRIOLA
CEO, NUCOR

Testimony before the U.S.-China Economic & Security Review Commission
China's Shifting Economic Realities and Implications for the United States
John Ferriola
Chairman, CEO & President of Nucor Corporation
February 24, 2016

Thank you, Co-Chairs Cleveland and Wessel, and members of the Commission, for the opportunity to testify before you today on global steel production overcapacity. I am John Ferriola, Chairman, Chief Executive Officer and President of Nucor Corporation, the largest steel producer and recycler in North America. I also serve on the boards of the American Iron and Steel Institute and the World Steel Association.

Global steel production overcapacity has been a problem for a long time, but today it is a crisis. Overcapacity has led to a significant increase in unfairly traded imports entering our market, stealing recent demand growth from more efficient U.S. producers. Last year, finished steel imports accounted for a record 29 percent of market share. At the same time, domestic capacity utilization averaged only 70 percent, and fell as low as 60 percent in the final weeks of 2015 (see Chart 1).

China is the main driver of production overcapacity. The speed and scale in which its steel industry grew in the last 15 years is unprecedented. In 2000, China had roughly the same annual steelmaking capacity as the United States– just over 100 million tons. Today, China's steelmaking capacity is 1.2 billion tons. It went from being a net steel importer to being the largest steel exporter in a matter of years.

Just how bad is the overcapacity problem? According to the American Iron and Steel Institute, it is estimated that global steel production overcapacity in 2014 was more than 700 million tons per year, 425 million tons of which was China's overcapacity. This is much worse than the steel crisis of the late 1990s, when nearly two-thirds of the U.S. steel industry was in bankruptcy. At that time, global steel overcapacity was estimated to be 300 million tons.

China's massive buildup of steelmaking capacity was not driven by market forces, but by excessive government intervention in the market. The Chinese government literally owns most of the steel industry. China has subsidized the growth of its steel industry through grants, low-interest loans, free land, low-priced energy and other raw material inputs. It also limits foreign ownership of steel companies, restricts some raw material exports and creates import barriers. Additionally, China manipulates its currency in order to drive exports of all of its manufactured goods, including steel. Simply stated, the Chinese government is a company disguised as a country engaged in economic warfare.

Last year, China exported a total of 123 million tons of steel (see Chart 2). To put that number into perspective, China exported more steel last year than all three NAFTA countries produced combined. China's exports are flooding every market around the world, creating a domino effect on trade flows. When Chinese steel displaces a country's home market, that country is forced to export its steel as well, which often ends up here because we have the most open market in the world. Other countries are more aggressive than the U.S. in putting safeguards and tariffs in place to stem the tide of steel imports. As a result, the U.S. market is a magnet for unfairly traded imports.

China's steel exports are expected to remain high this year. China's economic growth appears to be slowing sooner than experts anticipated. The slowdown in economic growth is impacting steel demand in China, which was forecast to drop 3.5 percent last year and 2 percent this year. Steel consumption in China peaked in 2013, and its industry is losing money. According to the China Iron and Steel Association, its member companies lost 10 billion dollars last year.

Steel companies in countries that play by the rules are paying the price for overcapacity. While foreign governments prop up inefficient steelmakers, lower-cost and efficient producers in market economies are the ones that end up shutting down. That is not how a functioning market is supposed to work. This market-distorting behavior is creating real harm for American workers. The American Iron and Steel Institute estimates that 12,000 layoffs were announced in the steel industry last year. Job losses reverberate throughout the entire steelmaking supply chain and into our local communities. For example, in 2015, global overcapacity and low capacity utilization rates in the steel industry contributed to the loss of 2,000 iron-ore mining jobs on Minnesota's Iron Range alone.

Consistent with our long-standing practice, Nucor has not laid off a single teammate due to economic factors. However, our nearly 24,000 teammates and their families are suffering the impacts caused by the overcapacity crisis every day. Our teammates' pay is tied directly to the number of quality tons, safely produced – when unfairly traded imports capture greater and greater market share, they are literally taking money out of our teammates' pockets.

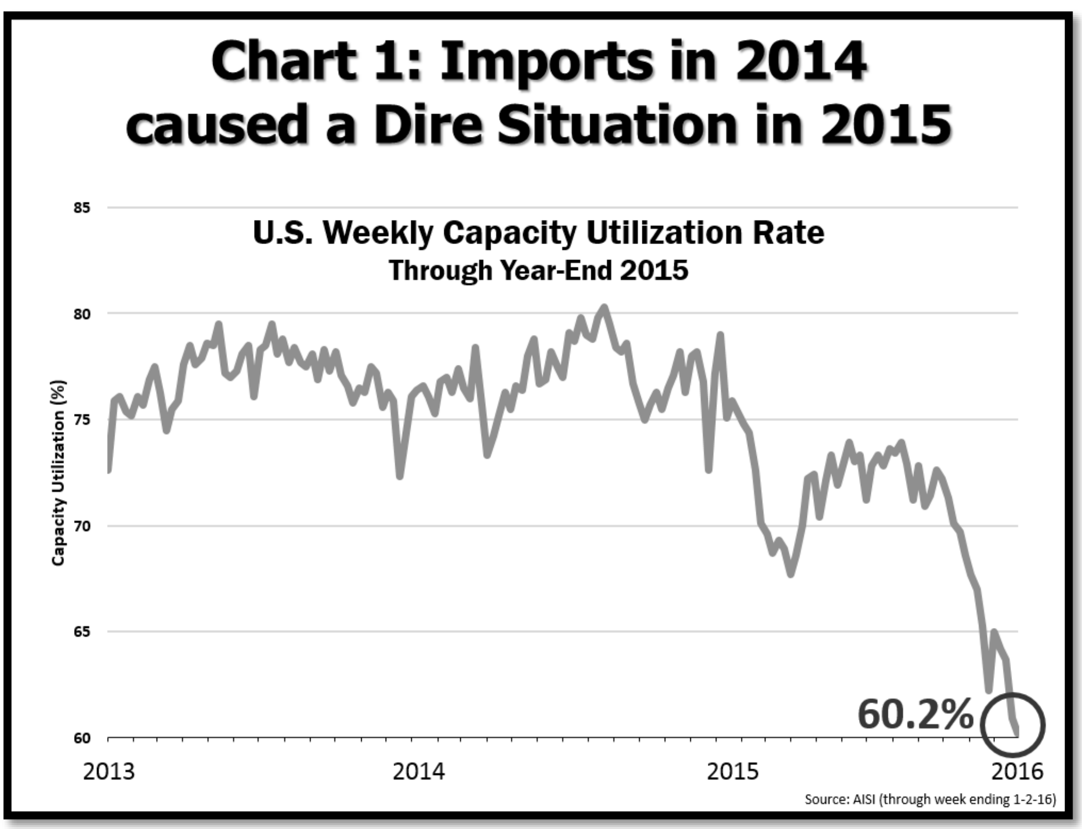
The uncertainty created by global overcapacity puts investments in the domestic industry at risk. In 2014, Nucor purchased Gallatin Steel, a flat-rolled mill in Kentucky for 770 million dollars. The mill has traditionally produced a variety of products for the energy market. Since that acquisition, a flood of unfairly traded imports targeting that product market, combined with the effects of lower oil and gas prices, has wiped out demand from that sector. Although we have been able to keep our no lay off practice in place for our nearly 500 Nucor Steel Gallatin teammates, they are bringing considerably less money home to their families each week. That is not the case for every steel company. A neighboring Kentucky mill is currently shut down because of the surge in unfairly traded imports, with 700 employees now out of work.

Fortunately, there is a growing international consensus that more needs to be done to tackle this overcapacity crisis. Like us, our trading partners – in the E.U., Turkey, Japan, NAFTA, and elsewhere – view this massive excess capacity as a threat to the viability of their steel industries. In fact, the OECD Steel Committee recently called for "immediate action to address the excess capacity challenge" and the "current steel crisis." Last June, OECD Steel Committee Chairman Risaburo Nezu warned that "a failure to address or halt market distortions will result in subsidized and state-supported enterprises surviving at the expense of private and efficient companies operating in environments with minimal government support." In my view, there must be cooperation from all major steel-producing countries and a commitment from governments to get out of the steel business. No ownership, no control, and no subsidies. The upcoming OECD High Level Meeting in April is a step in the right direction, as is the ongoing cooperation among the NAFTA governments. But, more needs to be done. Unless China deals with its state-sponsored overcapacity, no solution will be effective.

China recently claimed it will cut capacity by 100 to 150 million tons, though it has failed to specify a time frame or a strategy to achieve these reductions. Based on past behavior, we are skeptical that this will actually be achieved. In fact, the exact opposite may occur. Recent reports suggest that Chinese state-owned enterprises are buying and restarting money-losing capacity. Without meaningful trade relief as the hammer, China will always prioritize its internal need to maintain employment and Communist party control. The U.S. and our trading partners should accept nothing less than these reductions, and then some. China should provide a specific capacity-reduction plan, and we should strictly verify those reductions.

Overcapacity and other government interventions in the steel market have to be addressed in a comprehensive manner. The future of our domestic industry depends on it. Immediate steps need to be taken to remove inefficient excess capacity from the market and foreign governments must step aside and allow market forces to operate. If not, our country's steel industry – and the more than one million jobs it supports – will continue to disappear before our eyes.

Thank you.



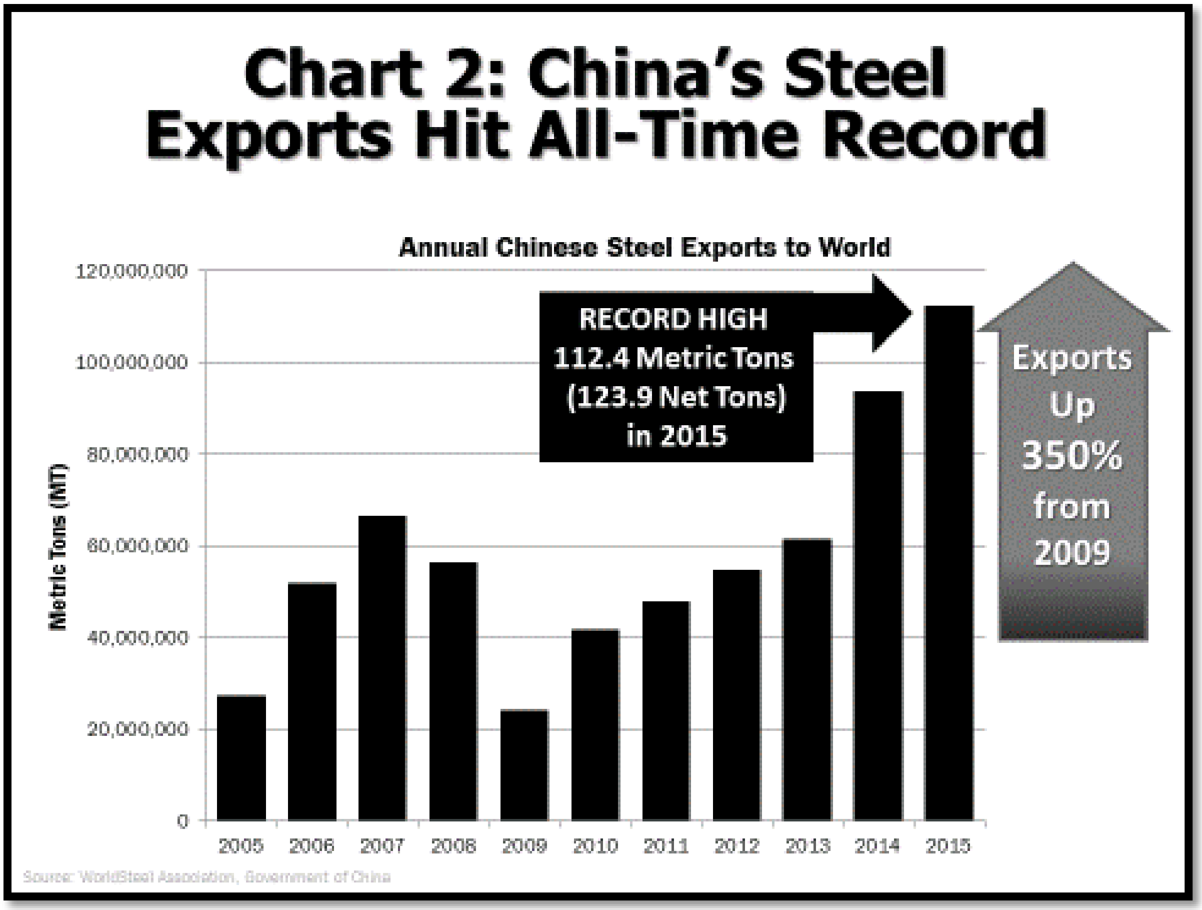


Chart 2: China's Steel
Exports Hit All-Time Record
Annual Chinese Steel Exports to World
RECORD HIGH
112.4 Metric Tons
(123.9 Net Tons)
in 2015
Exports
Up
350%
from
2009
Metric Tons (MT)
120,000,000
100,000,000
80,000,000
60,000,000
40,000,000
20,000,000
0
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
Source: WorldSteel Association, Government of China

PANEL III QUESTION AND ANSWER

HEARING CO-CHAIR WESSEL: We appreciate all your testimony, and I'm sure the associates who are subject to your no-layoff policy are even happier so thank you for being here to each of you.

Terry, you talked about taking exceptions, which could be done by China on its own or we could do it with China's consent. Mr. Ferriola, you talked about the crisis that exists. I know there are a number of trade cases going on, and it appears that a lot of them are proceeding but some of that appears to be sort of "whack-a-mole," that we go after one or two products, high-value products that are covered by our laws. Then it seems to seep in from other markets. So it may be a larger solution is needed.

How much time do we have? I think, Terry, you talked about the U.S. and WTO, which is three to five years probably. You talked about OECD. There's also the U.S.-China Bilateral Steel Dialogue. How long can this go on with your no-layoff--how long can you afford a no-layoff policy? How long can the other steel manufacturers survive in this market?

MR. FERRIOLA: If I may begin, it's not a question of how long we can continue our no lay-off practice. We will continue it indefinitely. The real question is, how long will we allow our teammates to suffer by reduced pay? I don't think we have three to five years. This is not a problem any longer. This is a crisis. So the real question is how long will other companies continue to survive in the United States?

Take a look at some of the publicly disclosed financial information from last year's performance of some of our competitors. One of our major competitors, ArcelorMittal, reported a loss of $8 billion. Now, it's true that four billion of it was write-offs basically from equipment that had to be shut down as a result of illegally traded, unfairly traded products, but still four billion in true losses, that's a big number.

U.S. Steel, another long-term company, an establishment in the United States providing many jobs for generations, lost $1.5 billion. So the question is: how long can these companies continue to sustain these huge losses as a result of these illegally traded imports before we lose an industry, before the steel industry goes the way of the textile industry or the furniture manufacturing industry in North Carolina?

But this is much more critical than textile or furniture manufacturing. If we lose steel, we lose the ability to defend ourselves militarily. Steel is crucial to our country's national defense--absolutely crucial. Can you imagine a world where we could not produce steel products to support our military? Where we had to rely on foreign countries to provide the steel for our tanks, for our helmets? I can't imagine such a world.

So a short answer to your question-- we can't afford to wait. Period. It's a crisis that needs to be addressed now, and it needs to be addressed strongly. Our trade laws need to be enforced robustly, and, frankly, we need to simply enforce the laws that we have on our books and insist that China begins to play by the rules that they agreed to when they joined the WTO.

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

MR. STEWART: Yeah, I certainly agree with Mr. Ferriola that the timing is immediate, and the problem is that there are no immediate easy solutions. Safeguards give you the ability to go after the entire world at once, and it has a short time fuse so that is a possibility.

Seeking a waiver at the WTO if there was actually the political will to pursue it, either from China or from its trading partners, is something that could be done quickly. The WTO case is about the only thing that is out there that gives you leverage to get China to close capacity it is unwilling to close on its own.

Typically the Chinese plans to close capacity are laid out in five-year time frames, and within five years, you will have lost a good deal of many industries, not only here but in other parts of the world. So it is a crisis of kind of novel proportions, and it's not clear that there is the political will anywhere in the world to deal with it on a time frame that is meaningful and that will prevent most of the dislocations from occurring here or elsewhere.

HEARING CO-CHAIR WESSEL: Come another round I have some follow-ups. Carolyn.

VICE CHAIRMAN BARTHOLOMEW: Thank you very much, and I have to say how nice it is to see someone who has come from the plant floor and can speak directly to the impact on American communities of Chinese economic practices.

I have a general question for all of you, but, Mr. Ferriola, I want to start, you talked about how important American steel is to the U.S. defense industrial base, which I was going to ask about. But this problem is being experienced by steel mills in the worst possible scenario--if we lost our steel industry. Are our allies being any more successful in making sure that their steel industry doesn't go the same way?

MR. FERRIOLA: As I mentioned in my statement, many other countries are taking more immediate and, frankly, stronger action to make sure that their steel industries compete on a level playing field. I want to make sure I stress that point. I use that term a lot--"a level playing field"--because I'm here to tell you and anyone else, and I will look everybody in the eye and make this comment: given a level playing field, the American steel industry will compete successfully against any company or country in the world.

We have the technology. We have the resources right here in the United States. We have the raw materials that we need. The market is located right here in the United States, which gives us a logistics advantage, and most importantly, we have the best asset right here in the United States--the American steel worker, the most efficient and productive in the world.

So, yes, I'm sorry, a short answer is yes.

VICE CHAIRMAN BARTHOLOMEW: That's okay.

MR. FERRIOLA: Other countries are taking more aggressive action than we are in the United States to protect their industries. But we don't want to rely --even on our allies--for steel that we need for our military forces.

VICE CHAIRMAN BARTHOLOMEW: Right. Thank you.

You mentioned that China is a company masquerading as a country. And I wanted to ask all of you--I mean China has a national industry policy, and I wanted to ask all of you if you think that the United States needs one?

MR. STEWART: Well, there certainly are times when one feels that one would like it, but if you look at the problem of excess capacity, excess capacity, in fact, flows from the challenges of picking winners and losers. And so there are upsides and downsides to it.

I think that one of the challenges that we face is we have a world trading system that doesn't accurately reflect the conditions of competition we face with a major nation like China. The rules were not designed for them. They didn't participate in their development, but it is also the case that the rules we have don't reasonably deal with the problems that they create.

So while there are sectors where one would say it would be good if we had a national industrial policy, you can't look at China and say that it has done well for the world. It may have done well for them in the short-term.

VICE CHAIRMAN BARTHOLOMEW: Mr. Haft.

MR. HAFT: Thanks.

And if I could just echo the original question about what other countries are doing. Part of the challenge with China's steel industry is that technically it's owned by the state, but it's also made up of mostly small guys. So it's made of like 1,200 small producers. Maybe about 70 are thought to be larger. And so the issue is, you know, how do you tamp down on safety on this fragmented industry?

Japan has made some strides in food and in pharmaceuticals where they've actually been able to set up much more stringent supplier certification standards. So basically going to the source and saying, okay, you cannot export to our country unless you abide by these strict standards.

The issue with Chinese steel from these tiny, tiny producers is that it tends to be very, very low in quality. So I think a near-term thing--and I agree with Mr. Ferriola that our steel is more competitive certainly than China's--so one solution might be to try to tamp down on what steel gets exported to us by raising the standards at the plant floor in terms of what we accept from China across the board.

MR. FERRIOLA: You know, I'm a firm believer that two wrongs don't make a right, so I will not say that we should follow the practices of China, which are wrong. Let me stress that point. That said, we have to protect our industry.

A couple of comments about the long-term effects. Mr. Haft has referred several times to the safety issues in China. I have been to China. I have visited Chinese steel mills. I am here to tell you that you do not want to live near and you certainly do not want to work in a Chinese steel mill. They are unsafe. They are filthy. They are disorganized and they are dangerous--extremely dangerous.

It's wrong that we allow companies and countries that allow that to take place to compete in our marketplace. Listen, certainly we don't want to go back to operating that way, and we will not go back to operating the way they operate. Therefore, we are put at a competitive disadvantage.

It costs money to make sure that steel mills do not emit toxics or greenhouse gas. It costs money to make sure that we have safe equipment and safe factories for our teammates to work in. It takes money to pay your teammates a fair wage that they can support their families in the way their families should be supported.

But all of that puts us at a competitive advantage. We have to insist as a country that if we're going to allow countries that do not provide safe, environmentally friendly, efficient mills to operate, they have to pay a price to bring that product into the United States. The way to do that is through our trade laws, which include safeguards and tariffs.

I hear the term "political will" used a lot up here, and I recognize that it's certainly lacking. Well, it's time that we get some political will. It's time that the people who we elect to represent us in Washington have the moxie to say, “This is wrong, and we're going to fix it.”

HEARING CO-CHAIR WESSEL: Senator Dorgan.

COMMISSIONER DORGAN: Thank you very much.

Let me make a comment first. The first book I wrote was titled Take this Job and Ship It, and I describe in great detail much of what we're talking about, and it occurred to me then, and it occurs to me now, especially in the light of the testimony from the three of you, that it's not as if we don't have leverage. We have unbelievable leverage with the Chinese. We are cash cow to their hard currency needs with respect to the abiding, apparently forever, deficits year after year after year in trade that we run with China.

And so it seems to me that the leverage we have we just don't have the will to use, and when I say leverage, everybody chants the mantra of free trade, and some of them tattoo it on their arms, but the fact is what we really care about is fair economic competition in an increasingly competitive world. So we determine where do jobs exist that are good jobs that pay well that allow people to do well? Where do you experience economic growth and so on? So there's a lot at stake here.

And it seems to me that any attempt at any moment by anybody here in our nation's capital to begin to address this issue with some sort of response finds it detoured very quickly through the dark tunnel of foreign policy. It is always that you can't use the leverage you have because we got to run it through the State Department; this is about our relationship with China.

Well, I understand about relationships and so on, but I also understand that if you're involved in fierce economic competition, you have to stand up for your economic interests, and standing up for interests means that you demand fairness, and when it doesn't exist, you take action. None of that now exists, and so, Mr. Ferriola, your testimony here is helpful because it continues to remind the country that we can't continue to allow this without very significant damage to our country and to our economy.

So, let me ask the three of you to describe, if you--tell me do you agree that we have unbelievable leverage with the Chinese if we wish to use it? Mr. Stewart, do you agree with that?

MR. STEWART: Senator, yes, I do, and I think that one of the scandals in American trade policy is that the intellectual elite have chosen to apply a standard to our conduct that they refuse to apply to our competitors. All right. I've been doing this a lot longer than people probably would like that I have done it, but I can tell you that back in the Clinton years, the popular theme of economists was the U.S. will run a trade deficit as long as it runs a budget deficit; right?

Then we ran a budget surplus--

COMMISSIONER DORGAN: Yeah. Turns out not to be true, doesn't it?

MR. STEWART: --that argument disappeared.

COMMISSIONER DORGAN: Yeah.

MR. STEWART: Economic theory would say that China having outgrown the world for the last three decades should be wallowing in trade deficits. The reason they're not is they control their market and access to their market, and the number of violations of their obligations to the WTO are extraordinary. And the system doesn't have the capacity at the WTO, and for the reasons you say, there's not the political will to bring dozens or hundreds of cases against them for all of the violations that occur.

COMMISSIONER DORGAN: And Mr. Haft, you described the increases in exports to China from 40 states and so on. But the fact is--and your contribution and your testimony is very helpful to us because you set out that area of exchange--but the fact is our exports to China are pretty pathetic.

I mean we should expect much, much more because when you talk about doubling or tripling or 30 percent or 50 percent, but take a look at the base. It makes it look like, oh, my gosh, this is unbelievable. But it is not!

But the fact is it's a pretty pathetic response. I want to, as I end this, say to Mr. Ferriola, you come here a lot, I assume, and you're saying I run a big company, this company is in some difficulty, not because we can't compete, but because the rules of competition are not being enforced fairly. So if you could, if you could have the ear of someone here today in Washington, D.C., who would it be, and what would you tell them?

I mean you have our ears, but I'm talking about, if you could meet with the President or the people that run the Senate, I mean--

MR. FERRIOLA: That's frankly a very easy question to answer for me. Here's what I would tell them. Do what is right. At Nucor, we have a saying: we do what is right all the time. Always. Even when no one is looking, we make sure we do what is right.

We have laws in place. Enforce them. The law is the law. I'm tired of hearing about geopolitical considerations. They're two separate events. We have to recognize that. We're not going to have to worry about geopolitical considerations if our country and our companies in our country are bankrupt.

So I would tell them: do what is right. You know what the laws are. Enforce them. Do what we have elected you and placed you here in Washington to do for us. Represent us.

If I may just make one more comment because I have to say this. You mentioned about free trade and having it tattooed on your arm. I'm not a believer in tattoos, okay, but if I had a tattoo, this is what I would put on my arm. I'd put "free trade" because I absolutely believe in it, but there would be a second line that would say "but fair trade." Free but fair trade is what the market is entirely about, and that's the best way to ensure global prosperity.

COMMISSIONER DORGAN: Mr. Chairman, thank you very much. That was probably therapeutic for Mr. Ferriola and myself.

[Laughter.]

MR. FERRIOLA: I apologize. I apologize.

MR. HAFT: May I respond since I was directly asked a question?

HEARING CO-CHAIR WESSEL: Yes.

MR. HAFT: Briefly, briefly. And I thank you. So Senator, in terms of the base, and I agree that it is pathetic in the amount that we export because we could be exporting so much more, but if you compare the actual value of what we export, China's right behind Canada and Mexico, which are our immediate partners to the north and to the south.

So the base is in spitting distance to our two other largest export markets, and China's still our fastest-growing export market. That said, we are the much bigger 800-pound gorilla in terms of what we buy, and I agree with you that we could be exerting much, much more leverage that we don't exert in terms of pushing safeguards onto our imports, and there are other countries that are doing this.

I mean when heparin happened, and a hundred, over a hundred Americans died in hospitals, we had two inspectors in the field with the FDA--two. We've been able to fight tooth and nail to get that up to 17, but I mean that's disgraceful given the amount of everything we import from China, including steel, but also pharmaceuticals and food, et cetera.

So I mean I believe that if we put in place a much more stringent and comprehensive system to inspect and prevent unsafe factories from exporting to us, that would actually add a lot of costs into the total delivered price of what we get from China and would have the effect of protecting consumers here in this country, and that's levers that we don't use that other countries are using, like Japan, and we could be as well.

COMMISSIONER DORGAN: Thank you very much.

MR. HAFT: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Cleveland.

HEARING CO-CHAIR CLEVELAND: I actually want to focus on what you were just talking about, Mr. Haft, but before I do that, I am not part of the intellectual elite so I am not sure. I asked my colleague here whether he was, and he assured me that nobody has ever used--

[Laughter.]

HEARING CO-CHAIR WESSEL: Neither elite nor intellectual.

HEARING CO-CHAIR CLEVELAND: Right. For either one of us. So I think for the purposes, I don't want to dwell on this particular piece, but I think it would be very helpful for us if you--I keep hearing we're not enforcing the law and we're not doing enough. If you could provide for the record the specific laws that would pertain to this issue and that you feel are not being adequately enforced or upheld, that would be useful.

I'd like to turn to this issue of safeguards and look at it from two different perspectives. The Chinese leadership obviously is under a lot of pressure because of buildings falling down and, you know, children dying from toxic substances in their food. So I've never seen the government not take action to serve its own interests ultimately, and I don't think the political hue and cry has reached a tipping point in terms of a threat to the Party, but I do remember many, many years ago, back when dinosaurs roamed the Earth, and I was promoting tobacco sales to China, they had a very robust infrastructure when it came to whatever blue mold is which afflicts Kentucky tobacco. And it was a process that we viewed as delaying the ultimate sale, but ultimately they argued it was a health issue.

So if you were advising Xi in terms of the safety, health and well-being of his own population, which sectors would you think are the most critical to address, and how would you go about doing that because I think whatever advice you would provide to the Chinese in terms of their own well-being is obviously something that would serve our export base and import base as well?

MR. HAFT: Thank you.

I think first and foremost would be agriculture. China lacks arable land, right, so you can fit the arable land that China has on the state of Texas. You know their water is mostly contaminated. I think 90 percent of the aquifers are contaminated. The rice is now seen to be lead laced, et cetera. You know we imported 1.4 billion tons of food from China last year, and the agricultural sector is also an input into the pharmaceutical sector. So the reason heparin came to bite us was because raw heparin is created from the mucus of pig intestines, right, so the issue with China's ag sector is that it's basically a hundred years behind ours or more--yeah, just after lunch is a perfect time to talk about that.

[Laughter.]

MR. HAFT: So China's ag sector is made up of about 140 million family farms, and most of them are very primitive so they're tilled by hand and beast. So getting the agricultural sector organized is a huge project, but one that I think is critical to China feeding itself and also not poisoning the world.

And I think some of the laws that could be implemented in organizing ag could help in organizing other industries like steel. You know we see that buildings fall over in China. I mean the Sichuan earthquake happened. Bridges are falling all over the place. Part of that is fraud because they do this practice of steel thinning, you know, where they're thinning the rebar and then selling it.

But another part of it is that they're mostly small suppliers that don't know what quality is. So rationalizing that chain could be something that they do if they learn how to do it from agriculture. But part of that runs directly against what Xi is trying to do with his Party because it allows--I mean you need free flow of capital and freedom to own your own land and better corporate governance in order to solve these problems, and that's not something that's going to happen any time, I think, within this generation.

So in the meantime, I believe we need to be really pushing upstream in the Chinese supply chain to try to raise the quality standards on what we allow our country even to let in in every industry because right now we're kind of sitting at risk to every Chinese export there is.

HEARING CO-CHAIR CLEVELAND: I'm hearing you say you'd start with the agriculture.

MR. HAFT: I would start with ag and--

HEARING CO-CHAIR CLEVELAND: And then what?

MR. HAFT: And move from there.

HEARING CO-CHAIR CLEVELAND: To?

MR. HAFT: Well, okay, so from agriculture, move to pharmaceuticals, and then from pharmaceuticals, I would move to steel.

VICE CHAIRMAN BARTHOLOMEW: By the time they get there, our steel industry will be done.

[Laughter.]

MR. HAFT: Well, so, in the meantime, let's do what Japan does, right? So Japan basically made it very, very difficult for Chinese suppliers to qualify to sell to the Japanese market. I mean right now we basically let anybody sell to us, so we need to really raise our standards in terms of what factories are allowed to sell to us and why, and then we need to be able to increase our inspection force to be able to go and look at these factories, inspect them, and give them a yes or a no.

I mean right now we have very, very few inspectors in the field in any industry, probably none in steel at the moment. You know what we have is with the FDA, and that's a very, very small force.

HEARING CO-CHAIR CLEVELAND: Please.

MR. FERRIOLA: I would suggest that we could even start in a more basic way--one that wouldn't require a whole lot of inspection. Take a look at the environmental impact that the Chinese steel industry has. And we need to remember, this is one globe and one environment. The bad air that is over Beijing today is going to be over LA in seven days, and no one needs to go to send an inspector to see how much pollution is taking place.

Whenever there's a meeting in China of official governments, what do they do? They shut down the closest steel plant for a week. When they had the Olympics, they shut down a steel plant and wouldn't allow it to operate so that they could have clean air to breathe while they were participating in the sporting events.

HEARING CO-CHAIR CLEVELAND: Well, apparently they don't care too much about the G20 because when I was there with that, they did not shut down anything.

MR. FERRIOLA: It was pretty bad. Well, I'll tell you what, and again this is maybe not the thing to talk about right after lunch, but a few months ago, I had to spend three days in Beijing. When I came home--and I have some colleagues in the back who can attest to this--my sinuses were so infected they bled for almost two months before I could get them to stop bleeding. So I guess my point--

HEARING CO-CHAIR CLEVELAND: Let's move on.

MR. FERRIOLA: Okay.

HEARING CO-CHAIR CLEVELAND: Unless anybody else would like to share bodily functions.

MR. FERRIOLA: My point is this--I apologize for that.

HEARING CO-CHAIR CLEVELAND: No, it's fine.

MR. FERRIOLA: My point is this--

HEARING CO-CHAIR CLEVELAND: I'm not part of the intellectually elite, and I'm not offended.

MR. FERRIOLA: We don't need to have major inspections of people on the ground. Everyone knows this is happening. Everyone knows. I applaud your approach. We need to go over. We need to say, “Hey, if we require our steel mills--appropriately-- to capture 99.998 percent of all emissions of all types, then if you want to sell steel in the United States, you have to capture more than 50 percent,okay?” It would be great if we could get them to capture 99.998. But that's a simple approach that we could take and one that supports our current administration's policy of global climate control, of improving the climate globally. What an easy way to make this happen.

HEARING CO-CHAIR WESSEL: Commissioner Tobin.

COMMISSIONER TOBIN: Great. Thank you.

I agree that that is an easy approach. Coming at it through that safety angle, coming at it through the different sectors, and as you were speaking, Mr. Haft, you described concentric circles of danger. So I'm wondering, Senator Dorgan talked about whether we have leverage. I think a place where we do have leverage is there could be a market within a market for what you called safe, environmentally friendly steel, and I think part of this is the will in business to market the fact that our U.S. steel is stronger and thus more safe.

So a combination of the regulations is needed and then business, I think, has to get smarter. Years ago I worked at Hewlett Packard, and in intensive care units, you saw nothing but the HP pacemakers in there because the doctors trusted it then, and I think, I'd like to hear your opinion on whether or not better marketing in business, Mr. Ferriola, and each of you, whether we can get smarter business-wise beyond the government response that you've sought?

MR. FERRIOLA: If I may start, I'll be brief because certainly we do that today. The challenge that we have is that we don't always have honest suppliers coming out of China. So what you see on the specification sheets that are properly made for different applications of the steel is not necessarily what's in the steel when you test it.

We do this randomly at our company. We will go out and buy Chinese steel from different producers and run the tests to see if the metallurgical composition is and the tensile strengths are what they're supposed to be. And time after time after time when we do this, we find that they fail, and we notify the appropriate government officials. They tell us we will take action, don't worry, and we never hear anything more about it.

We do try, and we do work to help our customers understand this and the dangers that it presents to them. And sometimes we get through. Other times it's more of a challenge.

COMMISSIONER TOBIN: Is there any role for the press to play in this in terms of highlighting such as with the San Francisco Bay Bridge or heparin?

MR. FERRIOLA: I think that there's a tremendous role for the press to play, and they should play it and do it fairly. They should look at these events. The Bay Bridge is just a classic example--it was done to reduce costs, okay. It ran 60 percent over budget. Took, you know, I think it was two years, if I'm not mistaken, to get everything corrected. Think about what we're talking about here. We're talking about a bridge that a million American families, children, go over everyday.

Yes, the press should play a bigger role, and we should make sure that Americans and American businesses understand the dangers when they participate in this kind of activity.

COMMISSIONER TOBIN: Mr. Stewart and Mr. Haft, can we come at it from business in any smart way beyond the regulation?

MR. STEWART: You can although part of the challenge in lots of areas is the inability to distinguish domestic versus imported product. For example, in agriculture, where you typically don't have good labeling, when you have a food problem, whether it be from China or Mexico or somewhere in the states, it tends to affect demand overall for the product, and so you have people that are very reluctant to get into that.

You also have had, at least in agriculture, Congress changed the law I think back in the mid-'90s to change the focus of USDA away from safety to facilitating trade, and that has made a major difference in terms of, you know, one of the problems with trade issues in the agricultural sector is that usually the first opponent you run into is your own government; right?

COMMISSIONER TOBIN: Yes.

MR. STEWART: And it really flows from that factor. Obviously we export a lot of product, and so they wear the export hat, and they don't really put the resources behind the import side, including the standards because standards should be there, and other countries have higher standards in a variety of products. So it's an area that can be done. It can be done by business, but there is a lot that government isn't doing and should be doing.

MR. HAFT: Yeah, I agree with both. The issue is that with all that we import from China, and you think about everything that we import from China, you know, most of that contains U.S. value added, especially upstream.

COMMISSIONER TOBIN: Yes.

MR. HAFT: So I mean if it's textiles, it's cotton from U.S. mill. If it's return air vents, you know, it's coming from recycled steel from the United States. If it's food, it might have inputs from here but also inputs from China, and the labeling hasn't kept up, and so American consumers don't know that if they're buying dog food that says "made in the USA," that actually there is some melamine in there that snuck in from a Chinese supplier.

So this is one place where I agree with you. Business could play a leading role because it's businesses, especially importing businesses, that are on the front lines, and they tend to lean back a bit when it comes to--

COMMISSIONER TOBIN: Right.

MR. HAFT: --forward deploying their resources up all the way to raw materials. Granted, you know, the Chinese don't open their doors with open arms and let you in, but with the power of the purse and the leverage of purchase orders, you actually can go upstream and check your raw materials and make sure that they're safe, or you take your business elsewhere.

So I think it's incumbent on businesses to be on the front lines of this. You know whether they're importing steel products--

COMMISSIONER TOBIN: Right.

MR. HAFT: --or food or pharma, and then government riding herd to put the right regulatory structure in place.

COMMISSIONER TOBIN: And two things before I yield back. Maybe starting with steel would be smarter because of the very things you mentioned, Mr. Stewart, and this morning--the other remark I'll make is this morning one of our witnesses spoke about an ecosystem, and that's why I do think that U.S. business, the U.S. government, plus China must all act to address this.

Thank you.

HEARING CO-CHAIR WESSEL: Chairman Shea.

CHAIRMAN SHEA: Thank you all for your testimony.

Mr. Ferriola, is it Bay Ridge or Bensonhurst?

[Laughter.]

MR. FERRIOLA: Well, I always tell people that I was born and raised in the South, south Manhattan, okay. Tribeca, to be exact.

CHAIRMAN SHEA: Okay. All right. Because you said, I see your bio, native of Brooklyn.

Let me ask you, is Chinese imported steel used by the U.S. military?

MR. FERRIOLA: I don't know specifics of that, so I really can't answer that question. I don't know where it might be used. The challenge that it has is that it comes in in so many different forms and in different products that some finished goods would find their way into the military that would be based upon Chinese steel.

CHAIRMAN SHEA: Mr. Haft.

MR. HAFT: If I could add, anecdotally, I know that the Coast Guard for years has been sourcing the chains for anchors from China, and I have heard time and time again that these chains shatter, frankly. I know, right, yeah, I mean anecdotally, but they tend to shatter frequently so this goes to the issue of low quality inputs in China.

MR. FERRIOLA: And if I may add one thing to that?

CHAIRMAN SHEA: Sure.

MR. FERRIOLA: We were approached by the government years ago--two years ago to be exact-- because they were having trouble getting high quality armored plate for the bottoms of the Humvees. And as a result, we added some equipment into one of our plate mills to heat treat and normalize the steel so that we could produce armored plate that we then sold to the military, and now it goes into the Humvees.

And I have to tell you what. As a company, we're really proud of that and our teammates at Hertford County are very, very proud of that fact.

CHAIRMAN SHEA: Okay. Well, let me just, hearing this discussion about how to deal with this, the overcapacity issue in the steel industry, it seems sort of insurmountable, I have to say. I mean if it is a crisis and it needs to be handled immediately, the options seem to be extraordinarily limited.

WTO cases: years, years of litigation. Even if you get a winning ruling, compliance will be spotty, and then you'll be enforcing the compliance. The inspection regime, environmental inspection regime, it sounds like a good idea. We had testimony from the FDA a couple of years ago about how hard it is to get inspectors into the FDA, and the Chinese fought it or dragged their feet for a long time on that. And so I think that's a nice idea, but it's going to take years to implement.

So it just seems to me the only real solution that would maybe have some power would be if the world got together, if the U.S., I assume British Steel still exists, the EU--

MR. FERRIOLA: I've got some bad news for you.

[Laughter.]

CHAIRMAN SHEA: It doesn't. Okay. It's gone.

MR. FERRIOLA: It's gone.

CHAIRMAN SHEA: It's gone. Okay. Well, the EU, if the U.S., the EU, and Japan at the highest political level said this is going to have to stop or we're going to do "x" and "y" and "z," that to me is the only way to really get their attention. So I don't know if that's going on right now. Maybe it is, but I would appreciate your thoughts.

MR. STEWART: Well, it certainly is the case that in the steel sector, this has been part of the bilateral negotiations between the U.S. and China for the last couple of years. It has similarly been on the EU-China bilateral negotiations. And you have Europe that has just brought I think three more sets of cases dealing with the Chinese imports. So--

CHAIRMAN SHEA: With the WTO?

MR. STEWART: No, no, under their trade remedy law.

CHAIRMAN SHEA: Trade remedy. Okay.

MR. STEWART: So comparable to bringing a dumping or countervailing duty case here in the United States. So both Europe and the U.S. are trying to deal with the issues that way. Japan has different ways of dealing with these problems, as has always been true.

But could there be an opportunity for collective action? Sure. There could be and there is obviously at the moment great pressure from the industries in a number of countries, including in Europe and here in the states, on the administration to do something.

MR. HAFT: Yeah, the question is what is the "x," "y," and "z"?

CHAIRMAN SHEA: Right.

MR. HAFT: Because I agree that we need to be coordinated with the EU and Japan. My concern with antidumping measures is just that we're protecting jobs in one part of the economy and we're hurting jobs in another part of our economy because oftentimes what we're importing from China is part of a global chain, and so I'm trying to think of a way to add costs to Chinese imports at the source. So if we worked with Europe and Japan, for example, to ramp up--it doesn't have to be just inspectors in the field, but in terms of the safe and clean steel, for example, what standards are being used in terms of what the environmental externalities are.

There was just an article in the New York Times about the rates of cancer near steel mills in China. So if we could make our import laws much more stringent together with Europe and Japan, I think that that could be a near-term remedy that would jack up the cost of all Chinese imports. I would rather see all Chinese imports become more expensive as opposed to selectively picking winners and losers.

MR. FERRIOLA: Frankly, I agree with a lot of your ideas. Unfortunately, they will take time, and as I said during my remarks, this isn't a problem anymore; this is a crisis. I don't believe we have time.

I started my career in the steel industry in 1974 working as an electrician on the night shift for a company named Bethlehem Steel. And in that role, I got to work with a lot of people right there on the shop floor, a lot of really good, hardworking people, just trying to make a better life for themselves and for their families. They worked hard, they worked safe, they worked efficiently, and they were good family men and women.

Unfortunately, in the year 2002, Bethlehem went out of business as a result of the onslaught of imported steel that took place in the late 1990s and in the early 2000s. In that short period of time, 14 U.S. steel companies, including Bethlehem, went bankrupt, went out of business. Literally, thousands of steel workers lost their jobs; their families were adversely affected.

The remedy that we had to put in when we reached that crisis situation was the 201, and I know that that's a real challenge. And it's kind of a desperate act, but sometimes desperate situations require desperate actions. And frankly, I feel that we are right now in a situation where we have a desperate situation.

The steel industry is once again threatened, I think, more so than it was in 2001, 2002 when we lost 14 steel companies. So I applaud all the ideas that we're hearing here today, and we should act on all of them. But we have to have an immediate response. If we can't do it through trade actions because our leaders are worried about geopolitical considerations, then we need to do something different, and I know everyone gets nervous when I say the 201, but if that's what it takes to save the industry and buy a time period when we can start to effect some of these more longer-term solutions, then that's what we should do.

CHAIRMAN SHEA: Thank you.

HEARING CO-CHAIR WESSEL: Senator Goodwin.

COMMISSIONER GOODWIN: Thank you, Commissioner, and thank the witnesses again for your time.

If my colleagues on the Commission would allow me to speechify a little bit. I really want to thank this particular panel for providing a real human face on the effects of these challenges, and as Century Aluminum alluded to in their written testimony, they closed a plant near my hometown in West Virginia just last summer for a lot of these very reasons, and it affected a lot of real people, including several very close friends of mine. 700 people lost their jobs; several hundred more retirees lost their health care benefits.

This is complex, it's nuanced, but it's not an academic exercise. And I think the frustration that the American people feel with issues like this is borne out of the very fact that they don't want to hear that it's complicated.

I have no doubt that it would take awhile to address these issues, but the longer we wait, the longer it will certainly take.

My testimony now--I do have one question. It's really to follow up on Mr. Haft's suggestion about the safety standards and really coming at these trade issues from an alternative angle--safety, environmental standards and so forth. And my question is how much has the administration considered, in its efforts to negotiate CO2 treaties and CO2 reductions globally and with China specifically, incorporating some of these standards into trade?

I mean needless to say, and as Century also mentioned in its written testimony, imagine if the costs borne by aluminum producers in China reflected their actual costs? Their actual market costs, the cost of electricity generation, the cost of the health effects of their plants, the cost of their environmental pollution? On what sort of competitive footing would that place them with domestic producers?

And how far down the line has the administration got, how much thought have they given to including that approach in the environmental negotiations themselves?

MR. HAFT: So this is not squarely in my wheelhouse, and I might defer to others who know better, but my understanding is very little frankly. Certainly on a bilateral basis with China, I would hazard a guess probably not. And so any kind of safety that we're seeing is probably coming industry by industry and company by company, but I do not believe that our government has put policy forward to bake in these safety standards in the way that we deal with China on a government-to-government basis.

And I believe that it should be because, to your point, that would put Chinese firms at, I believe, more of a competitive, quote-unquote "disadvantage." Part of the China price is because, you know, they're not paying for these quality control measures, the environmental measures. They're also often getting a value added tax rebate that gives them even more of an unfair price advantage so--

COMMISSIONER GOODWIN: And this may be a little bit outside the panel's wheelhouse as well, but it might be or prove to be a very effective way to reduce CO2 emissions if that's the goal; right?

MR. HAFT: I agree. I mean this is in China's interests also to try to tamp down on this issue because they've got a major environmental crisis happening right now that's impacting that country. So by solving safety, they'd also be tackling environment as well.

MR. STEWART: Let me just add to that, Senator. There have been efforts by certain industries and labor movements to have as part of the trade package the ability to tax differentials where products that would come in don't meet environmental standards.

That has been widely not supported on the Hill and by many large business organizations, particularly the import community, and it's been heavily fought by our trading partners who don't want to see it, but it obviously makes a great deal of sense and, in fact, gives meaning to the term "level playing field."

COMMISSIONER GOODWIN: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Cleveland for a question.

HEARING CO-CHAIR CLEVELAND: I just want to follow up on what Senator Goodwin raised, and I wonder if anybody has actually done a one-page analysis of what the real price would be for a prescription, a vitamin supplemental or--I'm trying to think of other things that--

COMMISSIONER TOBIN: Steel.

HEARING CO-CHAIR CLEVELAND: Steel.

COMMISSIONER TOBIN: Steel.

HEARING CO-CHAIR CLEVELAND: Steel. Have you put together anything that reflects the sort of added cost that might be included in what the price point might end up as with these kind of safeguards put in place?

MR. HAFT: So I have not--

HEARING CO-CHAIR CLEVELAND: For any product.

MR. HAFT: Right. For any product. I mean so I haven't done it from an academic perspective, but from a trading perspective, sourcing product in China for nearly 20 years, I've seen that, you know, when you go to the plant floor and try to put these kinds of quality controls in place, not only are you getting parity with American prices, but often they're more expensive than American prices because you don't have the efficiencies that you have in American companies bringing to bear.

So if you've got this long gangly Chinese supply chain, and think about 15 guys to make a pen, for example, 15 firms, you know, that are taking title to the goods and materials, and every player adds risk but also costs. So trying to wrap your arms around that actually makes China even less competitive and more expensive than sourcing in the U.S., which is why I scratched my head over the California Transportation Authority trying to save money from sourcing steel in China, then they go billions of dollars over because of these overruns.

So to answer your question directly, when these basic quality control and environmental measures are put in place, Chinese products tend to be on par or even more than American prices.

MR. FERRIOLA: If I may address that?

HEARING CO-CHAIR CLEVELAND: Please.

MR. FERRIOLA: In steelmaking, the laws of metallurgy dictate and physics dictate what goes into making a ton of steel. So we really understand very well what goes into the steel, how much of the alloys, how much raw materials have to be used, how much energy and gas and electricity. We know how many units per ton go into making a ton of steel.

So we do look at that, and when you look at the raw materials, how they have to source their raw materials, let's take China, virtually all of their raw materials come from the other side of the globe. So you've got a tremendous cost in moving the raw materials to China. We know how much gas goes into it. We know what we pay for an MMBtu of gas here in the United States. We know that in China it's two-and-a-half to three times that.

We know what we pay for a kilowatt or megawatt of electricity here. We know in China it's two times that. We know what costs they incur in moving the material from their factories to the marketplace here in the United States, and when you do the math, I can tell you, it is not on par. It is not even close. Okay. They are at a significant disadvantage, and I'm not even mentioning the efficiencies that you mentioned of the American worker. Taking that out because that's a little bit harder to measure, we know how many man-hours go into it, but we don't know how effectively they go into it.

So excluding that, you can take a look at the typical ton of steel, and we could come pretty close. We could supply you with that one-pager very easily, but I will tell you that when you're living in a world of about $400 a ton steel, you're looking at a 25 percent disadvantage.

HEARING CO-CHAIR CLEVELAND: Thank you.

HEARING CO-CHAIR WESSEL: I'm reminded unfortunately, and Senator Dorgan, you may remember your old colleague Fritz Hollings had a great line that the only thing worse than being called a pervert in Washington was being called a protectionist.

[Laughter.]

HEARING CO-CHAIR WESSEL: And I think that, in addition to foreign policy concerns, is what's driving a lot of the concern.

To me it seems that, you know, we are, we have a lack of will here within government to do much of what our laws already provide or require.

Jeremy, you talked about the inspections. We have an existing MOU on food and on dietary supplements and prescription drugs. I believe of the 750 FDA facilities, or their comparable FDA facilities in China, our inspectors have been allowed into 15 of them, and in each instance, the Chinese delayed their entry into the facility by six weeks. So we don't have what you can have here of showing up overnight.

You talked about labeling of products, which was raised here. The WTO ruled that we couldn't have country of origin labeling on certain food products. Some in the steel industry have had to fight a melted and poured standard that might allow steel to ease improperly into our own market and be labeled as U.S. product that can be used under our sourcing statutes.

Terry, you talk about trade provisions, many of which this administration and every prior administration has the authority to self-initiate and has chosen not to. So we're all sitting here--to me it seems that this is really a question of will. To share Senator Goodwin's comments, thank you for coming up here, Mr. Ferriola, for coming from the shop floor. Your being here--all of your being here is important. But for a CEO who treats the people the way you are, coming up here is important.

We need a lot more of you. We need the administration to be using existing authority or the existing agreements and enforcing them aggressively. Then we can find out what the gaps are. The Department of Commerce isn't even administering last year's trade law appropriately and giving the benefit of the doubt to our trading partners when they're engaging in dilatory and stalling tactics, and the result is we're losing more and more production.

So if there are other areas that I'm missing, the melted and poured, and all these others, please let me know because we want to know what should the administration, what should Congress, be doing that it already has the authority to do?

Then we can talk about new tools. Finding new tools or getting new tools passed, especially this political year, is tough. There's a lot of existing authority that if properly used might be able to make a difference. So that's a statement, but any comments? Terry? Any other thoughts?

MR. STEWART: Well, several--

HEARING CO-CHAIR CLEVELAND: Stand up and cheer now.

HEARING CO-CHAIR WESSEL: That would be good. A wave. Short wave.

MR. STEWART: Several of the items in my paper, in fact, deal with what the administration can do on its own. It has long been the case that industries have to be injured to be able to bring a case. There's a threat of injury standard, which those of us who practice law view as you have to be injured to be able to show threat. You have to be near death to show injury, and that could be easily dealt with by the Commission. That is inherently an intrinsic function of the ITC.

Similarly, the Commerce Department in addition to kind of stricter adherence to its own regulations in the statute could put a big bill out there for our friends in China to see they will never get market economy status until they've dealt with this excess capacity, not just in steel but across the board.

MR. HAFT: I agree with that, and I think also I mean we're negotiating a bilateral investment treaty at the moment as well, and I know that I think more Chinese capital is coming into the United States than U.S. is going into China, but we still have leverage. I think using that negotiation process also to demand better standards and especially in overcapacity.

MR. FERRIOLA: Given this year that China will be seeking market economy status, given this year that China is going to want--and I realize they're not in the TPP--but they're going to want the TPP to pass, there has never been a better time for the U.S. to flex its muscles. And I applaud you, sir. You've listed every--you've listed every single thing that frankly is on the books today that if it's simply enforced will go a long way to solving this problem.

This is the year for the government to step up, show some moxie, do what needs to be done, and take advantage of the unique opportunity where we have them a little bit on the defensive, where we have something that we're offering that they want, to insist that they begin to follow the rules and show that they can play fairly before we let them into the game.

HEARING CO-CHAIR WESSEL: Carolyn.

VICE CHAIRMAN BARTHOLOMEW: I was going to ask another question, but I think--unless anybody--well, first, Mr. Ferriola, I actually serve on the board of Kaiser Aluminum, and I'm pleased that my colleagues raised aluminum as a sector that's also having some challenges, and we, also we're proud to participate in the Humvee. I don't know if we competed with you for that particular piece, but--

MR. FERRIOLA: Trust me, aluminum does not stop IEDs as well as steel so you did not compete with us.

[Laughter.]

VICE CHAIRMAN BARTHOLOMEW: There's a long debate we could have about aluminum versus steel. We won't--

MR. FERRIOLA: If there's any press, please put that in the latest story.

VICE CHAIRMAN BARTHOLOMEW: We certainly won't do that. We won't do that. But I want to go back to this sort of country of origin labeling issue we've talked about. Mr. Haft, you mentioned buildings collapsing in China, and I have to say that when I hear that buildings have collapsed here in the United States, I find myself wondering who made the rebar. Parking lots collapsed; buildings collapsed. We seem to be seeing that more frequently. And I wonder is there some way of tracking? I mean do people know when they do an investigation of these collapses, for example, where that product has come from?

And if I'm just, you know, I construct houses in Albuquerque, New Mexico. If I go to Home Depot to buy rebar or other steel components, do I know where those have come from?

MR. FERRIOLA: Frankly, if you go to Home Depot, you would not know. There are ways to track, and on larger projects, obviously, there's lots; everything is marked and can be traced back.

But unfortunately for the consumer buying locally in small amounts, it's virtually impossible. When it comes through the service center industry and then out to distribution, all tracking is lost, and that's a bad situation, by the way.

VICE CHAIRMAN BARTHOLOMEW: Yeah, it is, and, Terry, I know you have worked on these issues a lot. The WTO ruled against the U.S. on country of origin labeling on what? Is it meat products?

MR. STEWART: Beef. Beef and pork.

VICE CHAIRMAN BARTHOLOMEW: Would there be some way to structure a country of origin labeling on these construction materials that would not be subject to the same kinds of--

MR. STEWART: Yeah, the issue I think, if you start from a safety standpoint where you're trying to be able to trace back, then marking for purposes of resale in the states versus entry into the country is a lot easier to do. And so, yes, there clearly are ways that that could be done. The question is whether you can muster enough political will to get past--

VICE CHAIRMAN BARTHOLOMEW: We keep ending up at the same place.

MR. STEWART: --to get past the people who don't want to do it.

VICE CHAIRMAN BARTHOLOMEW: Right.

MR. STEWART: The opponents of labeling were not simply the Canadians and the Mexicans. They were the meat processors who much preferred a system in which they didn't have to provide to consumers the information as to where the product was from. It makes it easier to run their plants and they don't have to be concerned about it.

VICE CHAIRMAN BARTHOLOMEW: It's interesting because most people I know want to buy American when it comes to these things, but they don't know what American is. So I presume, Mr. Ferriola, that you do that as part of your marketing?

MR. FERRIOLA: We do, and there are some areas where it's very simple to do even when you buy on a local basis. For example, Nucor is in the fastener business, so if you're at Home Depot and you're looking to buy nuts or bolts, okay, look at the head. You'll see a little "N" stamped on there. That's the one you want to buy.

VICE CHAIRMAN BARTHOLOMEW: Have the Chinese not knocked that off? They haven't counterfeited that yet?

MR. FERRIOLA: They've worked on it, but we've caught them each time, and we've stopped them.

VICE CHAIRMAN BARTHOLOMEW: All right. Thank you very much.

HEARING CO-CHAIR WESSEL: Thank all of you for being here. Very helpful. We will and we may have follow-up questions and hope that we can have our staff work with you to get some responses.

We will break for ten minutes before the--

MR. FERRIOLA: Before you break, can I make just a very, very short statement?

HEARING CO-CHAIR WESSEL: Please.

MR. FERRIOLA: Because I feel absolutely compelled to say this. I come to Washington and testify in front of commissions and committees like this on behalf of my teammates often. I do not like it. I really do not like it. Okay. But I do it because it's the right thing to help our teammates.

But I have to say this: I have truly enjoyed this today. In all the times that I have come to Washington, I have never testified in front of a group as attentive, concerned, and as engaged as this group. I've watched you as we've testified and answered questions, and I see real attention, and I just wanted to say on behalf of us, thank you very, very much for that. We truly appreciate it.

HEARING CO-CHAIR WESSEL: Thank you for coming.

COMMISSIONER TOBIN: Thank you.

HEARING CO-CHAIR WESSEL: Thanks.

[Whereupon, a short break was taken.]

PANEL IV INTRODUCTION BY COMMISSIONER ROBIN CLEVELAND

HEARING CO-CHAIR CLEVELAND: Okay. The staff assures me that this is the best panel of the day because it's at the end of the day so they saved the best for last.

VICE CHAIRMAN BARTHOLOMEW: The bar is high.

HEARING CO-CHAIR CLEVELAND: Yeah, it is. I agree. I agree. I agree. It's been a terrific day, and I've learned a great deal. And so without further noise from me, China argues its WTO accession agreement mandates automatic conferral of market economy status.

In our final panel today, experts will offer their perspectives on this issue which holds critical implications for U.S. firms, industry, consumers, and trade remedies, as well as the global economy, as you all heard your predecessors testify.

First, we welcome Mr. Alan Price, a partner with the Washington-based firm Wiley Rein. Say that fast three times. In addition to being chair of the firm's International Trade Practice, he heads the firm's antidumping and countervailing duty practice. Also counsels clients on bilateral and multilateral agreements, trade legislation, customs regulation and WTO dispute resolution.

Mr. Price has written several papers on the Chinese government's support of the steel industry, and in September 2015, he coauthored a white paper on treatment of China as a non-market economy, which I read and is very good.

We welcome you back. You testified in 2006.

Next, we have Dr. Adam Hersh, a Visiting Fellow at Columbia University's Initiative for Policy Dialogue--which school is that?

DR. HERSH: It's an independent center.

HEARING CO-CHAIR CLEVELAND: Okay. Affiliated with any of the--

DR. HERSH: It was founded by Professor Stiglitz.

HEARING CO-CHAIR CLEVELAND: Oh, that's what I was looking for. Thank you.

Previously, he was a Senior Economist at the Roosevelt Institute and the Center for American Progress. Dr. Hersh's current research focuses on China's economic reform and policy--economic reform and policy--not reform policy--and the effects of trade and global economic governance on inequality and growth.

His forthcoming report evaluates the progress of China's economic reforms against statutory and market economy criteria. You've testified in 2012 and '14 so welcome back to you.

Third, we welcome Dr. Gary Clyde Hufbauer who has served as the Reginald Jones Senior Fellow at the Peterson Institute for International Economics since 1992. His previous affiliations include the Council on Foreign Relations and Georgetown.

Dr. Hufbauer also served as Deputy Assistant Secretary for International Trade and Investment Policy of the U.S. Treasury from 1977 to '79--good years--graduated from college. He has written extensively on international trade, investment and tax issues, including Bridging the Pacific: Toward Free Trade and Investment Between China and the U.S.; U.S.-China Trade Disputes; and NAFTA Revisited: Achievements and Challenges. Also he has testified in 2005.

Finally, we have Mr. Bernard O'Connor, who traveled from Brussels to be here today. The weather is very similar, I'm guessing.

[Laughter.]

HEARING CO-CHAIR CLEVELAND: Mr. O'Connor is the head of the Brussels office of the NCTM, one of the top independent law firms in Italy. Why don't you get to live in Italy?

[Laughter.]

VICE CHAIRMAN BARTHOLOMEW: He spends a lot of time there.

MR. O'CONNOR: Not so much rain.

HEARING CO-CHAIR CLEVELAND: Yeah. Better wine certainly.

His areas of expertise include trade defense, subsidies and state aids, and administrative procedures, including competition law and litigation. He has been practicing EU and WTO law for more than 25 years. What punishment.

His most recent cases are related to gas pricing in Russia, the impact of the WTO on the EU legal order, dumping from China, and EU free trade agreements in Asia.

Mr. O'Connor has written and edited a number of books on EU and WTO law and holds teaching positions at the State University in Milan--wow, and you're in Brussels--the World Trade Institute in Bern, and the University of Barcelona.

Thank you all for being here. You know the rules from being here before. We try to keep it to seven minutes because we're really good at questions.

So Mr. Price, would you please proceed?

OPENING STATEMENT OF MR. ALAN H. PRICE
PARTNER, WILEY REIN LLP

MR. PRICE: Good afternoon. Thank you, Hearing Co-Chairs Cleveland and Wessel, and members of the Commission.

I'd like to begin with the obvious question: is China a market economy? There's little real debate on this issue. The constitution of the PRC specifies that China is a socialist economy. Similarly, the Chinese Communist Party, the only legal political party in China, has emphasized the state must retain the leading role in the economy.

The United States, the EU, and Canada all address this question in detail and reach the same conclusion: China is not a market economy. The Chinese state owns a large part of the means of production. Two recent studies calculate that state-owned enterprises account for more than 50 percent of China's GDP. The state plays a central role in allocating resources, both through planning and regulation and through control over lending by state-owned banks.

The Chinese government tightly controls the value of Chinese currency, the RMB, rather than let the market set it. The Chinese government influences and even sets prices on a huge number of products, which means that China is not fulfilling its commitments under Article 9 of the Protocol of Accession to allow the market to set prices.

Continued government control of the economy has had profound consequences both within and outside of China. The State Council has admitted that excessive government control over the economy has led to distortions in prices and huge overcapacities that we just heard about from the prior panel.

The steel industry in China is a perfect example. It's well documented. The industry, which is dominated by huge state-owned producers, now produces half of all the steel made in the world, even though China has no natural comparative advantage in steel production, as you've also just heard.

The same is true for many other industries, including aluminum. China accounts for over half of the capacity to produce primary aluminum even though it has a comparative disadvantage to virtually all other suppliers in the world, including the United States.

The Chinese steel, aluminum and any number of other industries have reached their sizes only because they have received massive governmental support, and these industries have increased production far beyond what China could reasonably consume. They have exported the excess at low prices to the detriment of their competitors in the United States and elsewhere.

This, in turn, robs profitable sales from market-based producers in other countries who must charge prices high enough to attract capital and to retain capital. The consequences on Western industrial and defense capabilities are immense, as industrial and defense capabilities are inseparable.

The antidumping law has been the main instrument for addressing the harm caused by China's predatory export behavior. The Chinese government understands that. If other countries must use China's prices in dumping calculations, it can manipulate prices in China so that it will be impossible to show that Chinese products are dumped. Treating China as a market economy will effectively exempt it from the antidumping laws. The consequences for China's competitors in the United States and elsewhere would be disastrous.

The basis for China's claim that other countries must treat it as a market economy for dumping purposes after December 11, 2016 is that one provision, and only one provision, in

Article 15 of the Protocol of Accession expires on that date. However, the other provisions of the article remain in force and allow WTO members to apply nonmarket economy treatment so long as they give Chinese producers the opportunity to show that they individually operate under market conditions, something the U.S. currently does.

Yet China claims that because one sentence expires the entire provision expires. This is just wrong. I've explained it in detail in my various papers on this so we'll keep this to seven minutes, but there's really no basis for this.

China's claim, in essence, is that the United States, the EU and everyone else in the WTO agreed to treat China as a market economy after 2016 whether or not it was one. This assertion defies logic and is inconsistent with both Article 15(d) and the surviving portions of Article 15(a). That China has mischaracterized the effects of one sentence in 15(d) is made clear by examining many other provisions in the Protocol, like the special transitional safeguard that existed under Article 16. In Article 16, the negotiators certainly demonstrated that they knew how to terminate an entire article with clarity if they wished to.

This is decisive evidence that the parties to the protocol did not intend to require WTO members to automatically extend market economy treatment to China after December 11, 2016.

Until China fulfills its commitments under Article 9 and 10 of the Protocol, Chinese prices cannot serve as a reliable basis for dumping calculations, exactly the situation that the remaining portions of Article 15 address. Accepting China's claim would reward it for violating its commitments in Article 9 and 10 of the Protocol. It would also eliminate a major incentive to China for China to fulfil its WTO commitments.

Thank you.

PREPARED STATEMENT OF MR. ALAN H. PRICE
PARTNER, WILEY REIN LLP

WRITTEN STATEMENT OF ALAN H. PRICE
Before the U.S.-China Economic and Security Review Commission
February 24, 2016

The U.S.-China Economic and Security Review Commission has posed two of the most important questions facing the international trading community today: is China a market economy, and if it is not, is the United States nonetheless required to treat it as one? How these questions are answered will affect billions of dollars in trade and millions of jobs. In this case, the answers are actually quite clear. China satisfies none of the criteria for a market economy as enunciated by the United States, the European Union, or Canada. Nor do the international obligations of the United States require it to treat China as a market economy when it is not. Any decision to extend market economy treatment to China when China is not in fact a market economy would have severe negative consequences for the U.S. economy and the entire world trading system.

Is China a Market Economy?

A useful starting point in assessing whether China is a market economy is the stance of the Chinese government itself. The Constitution of the People's Republic of China states explicitly that "{t}he State-owned economy, namely, the socialist economy under ownership by the whole people, is the leading force in the national economy. The State ensures the consolidation and growth of the State-owned economy." A recent statement by the State Council, the highest administrative organ of the Chinese government, highlights the extent to which various levels of government in China interfere in the operation of the economy:

> Some local governments have excessively sought after speedy development, relying on attracting investment. They have provided land at discounted prices, tax reductions or exemptions, resources at discounted prices and other methods to attract business and investment, enabling repetitive investments and expansions in capacity. At the same time, market reforms of resource factors have lagged behind. Policies, regulations, standards, environmental protections and other guidance and restrictions have been weak. Investment mechanisms and administrative methods have been imperfect. Oversight, investigation, and enforcement have been insufficient. This has led to distortions in the prices of the factors of production, an insufficient market environment of fair competition, an inability of market functions to effectively play their role, no smooth channels for the exit of backwards capacity, and incessant intensification of the contradictions of overcapacity.[1]

The legal question of whether China should be treated as a market economy for antidumping purposes is a matter of national law. Three of China's major trading partners – the United States, the European Union, and Canada – follow a generally similar approach to this issue. Significantly, each has determined that China is not a market economy.

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[1] Guiding Opinions of the State Council on Resolving the Contradiction of Serious Industrial Overcapacity, Guofa (2013) No. 41.

U.S. Criteria for "Market Economy"

Under U.S. law, the decision whether a country must be treated as a market or nonmarket economy for antidumping purposes is assigned to the Commerce Department. In assessing whether China (or any other country) is a market economy, the Commerce Department considers six factors, including whether the country's currency is convertible; whether wage rates are the result of negotiation between management and labor; restrictions on foreign investment; the extent of government ownership of the means of production; and the extent to which the government controls the allocation of resources. The Department may also consider any other factors it considers appropriate.

In 2006, the Commerce Department conducted a detailed review, and concluded that China was not a market economy. Examination of the most recent evidence confirms that the Department's earlier determination remains valid, and establishes that China does not satisfy *any* of the criteria for a market economy.

1. *Currency convertibility*: In its 2006 assessment, the Commerce Department found that China controlled the value of its currency, the RMB, through significant restrictions on both the interbank foreign exchange market and on capital account transactions. The most recent report by the International Monetary Fund on China's currency policies notes the Chinese government continues to exert tight control over the RMB's exchange rate. The U.S. Treasury Department has reached similar conclusions.
2. *Wages*. The Department concluded in 2006 that wages in China were largely set as the product of negotiations between management and labor. However, the Department also noted that there no independent trade unions in China; that strikes are prohibited as a matter of law; and that workers are not able to freely move within the country. This limits the extent to which market forces influence the formation of wages. This situation has not changed since 2006.
3. *Foreign investment*. The Department found in its 2006 assessment that the Chinese government exerted substantial control over foreign investment, and in particular tended to direct forward investment towards export-oriented sectors of the economy. China continues to regulate foreign investment closely. Certain key sectors, including financial services, remain either closed to foreign investors or available only under tightly controlled conditions.
4. *Government ownership of the means of production*. The Department found in 2006 that the Chinese government intended to maintain or even increase its control over certain key areas – "pillars" – of the Chinese economy. The Chinese state continues to own a substantial portion of the Chinese economy. Two recent studies estimate that state-owned entities account for approximately 50 percent of Chinese GDP. The Chinese state owns many of the largest companies in China. Indeed, the twelve largest companies in China, by market capitalization, are all state-owned. State-owned enterprises dominate a number of key sectors in the Chinese economy, including petroleum, mining, telecommunications, utilities, transportation, and a number of industrial sectors, including the steel and automotive industries. Indeed, state ownership of some sectors appears to have increased since 2006. State ownership is especially dominant in the banking sector. Even where the Chinese government has indicated a willingness to reduce the extent of formal state ownership, it has also

expressed its intention to increase political supervision of corporate affairs through, for example, an expanded role for Chinese Communist Party supervisory bodies embedded in Chinese firms, both private and state-owned. Thus, even if formal state ownership is reduced, state supervision and control will remain.

5. *Government allocation of resources*. The Department concluded in 2006 that "the PRC government, at all levels, remains deeply entrenched in resource allocation." The Chinese government continues to play the central role within the Chinese economy in the allocation of resources. The Chinese government uses the financial sector, and especially the mammoth state-owned banks, as a major means of implementing its policy decisions. Banks are subject to legal rules requiring them to provide loans "according to the needs of the national economy." In particular, they are required to provide credit to "encouraged" projects and to give priority to support for certain industries. SOEs are the chief beneficiaries of the system, with the government using the state-owned banks to direct low-cost credit to them. As a result of these policies, SOEs have a privileged position within the Chinese economy.
6. *Other factors*. The Commerce Department cited a number of other factors in its 2006 determination as being relevant, including trade liberalization, the rule of law, and corruption. The Office of the U.S. Trade Representative has described China's adoption of the rule of law as "incomplete," and noted that the implementation of anti-monopoly laws in particular has been problematic. Corruption remains a pressing issue. China's implementation of a true rule of law – a prerequisite for a functioning market economy – remains unfinished.

The EU Criteria for "Market Economy"

Like the United States, the EU applies a number of criteria to determine whether a country is a market economy. These indicators include whether firms make decisions based on the market, rather than as the result of government control or influence; convertibility of currency; the existence of effective legal framework for the conduct of business and for the proper functioning of a free-market economy; and the presence of a genuine financial sector. The EU last examined this issue fully in 2008, when it determined that China was not a market economy. The EU repeated this conclusion in 2011.

A comprehensive recent study examined each of the EU criteria for market economy treatment in detail, and concluded emphatically that China is not a market economy under the EU standards.[2] As the discussion above showed, the Chinese government exercises enormous influence over the allocation of resources within China. Given government control over the financial sector, and especially the role of the large state-owned banks in that sector, China cannot be considered to have a "genuine" financial sector. Moreover, the rule of law in China, especially with respect to corporate governance and the conduct of business, remains incomplete.

[2] Taube and Schmidknoz, *Assessment of the normative and policy framework governing the Chinese economy and its impact on international competition* (2015), http://www.eurofer.org/Issues&Positions/Market%20Economy%20Status%20-%20China/articles/MES%20China%20Study_Taube_Executive%20summary-25June15__F.pdf ("*Aegis China Study*").

The Canadian Approach

Canada follows a somewhat different approach. In every antidumping investigation of Chinese products, the Canada Border Services Agency ("CBSA") examines whether "domestic prices are substantially determined by the government of that country and there is sufficient reason to believe that they are not substantially the same as they would be if they were determined in a competitive market." If the determination is affirmative, then CBSA will not use actual Chinese prices and costs.

Canada has consistently determined that the Chinese government does influence prices to the extent that they cannot provide a reliable basis for dumping calculations. Among the factors CBSA has identified are

- Chinese government policies and regulations concerning the product, including policies specifying participants in the industry, production levels, and technology
- State ownership of enterprises producing the product under investigation;
- Measures limiting the export of the product under investigation;
- Direct government control over prices for key inputs used in the production of the product under investigation;
- Government purchases of the product; and
- Government restrictions on the use or supply of inputs.

Economic Analysis

Under any of these three approaches, the only possible conclusion is that China is not a market economy. Economists have reached the same conclusion from an empirical perspective. Derek Scissors of the American Enterprise Institute, for example, stated in testimony before the House of Representatives Committee on Foreign Affairs in July 2015 that over the last decade the Chinese government has made no real progress towards increasing the role of the market in the Chinese economy.[3] Prof. Scissors singled out the state's domination of the Chinese financial system – its ability to "without legal or political delay, order the strongest institutions to save the weakest" – as an especially important characteristic. Because the Chinese government has ordered the state-owned banks to lend to state-owned enterprises in priority sectors of the Chinese economy, favored industries such steel and aluminum have built up capacity independently of any commercial considerations, with negative consequences for the rest of the world. Prof. Scissors also noted the regulatory protection and other benefits given SOEs, which "means the private sector is simply not allowed to succeed in the two dozen industries that SOEs dominate."

Conclusion

Whether U.S., EU, or Canadian law is applied, China is not a market economy. Economists have reached the same conclusion. The Chinese state continues to control the allocation of resources and to influence or even set prices through a variety of mechanisms, including its domination of the financial system, as well as through direct and indirect ownership of individual

[3] D. Scissors, *China's Stall*, available at https://www.aei.org/publication/chinas-stall/.

enterprises. Most tellingly, the Chinese government itself does not describe China as a market economy, and has indeed committed itself to (so-far unimplemented) reforms that would increase the market's role in the Chinese economy, while still allowing the state to play a decisive role.

Is the United States Required to Treat China as a Market Economy?

China claims that the United States is obligated by the terms of China's Protocol of Accession to the World Trade Organization to treat China as a market economy in antidumping investigations after December 11, 2016. This claim is unsupported by the actual language of the Protocol and is contrary to the underlying purpose of the relevant provisions of the Protocol.

I have addressed this issue in great detail in a paper entitled "China Can Still Be Treated as a Nonmarket Economy After 2016," a copy of which is attached. As the paper explains, when China joined the World Trade Organization in 2001, many WTO members expressed strong concerns about how the anti-dumping laws would apply to China. The continuing role of the Chinese government in the economy meant that members could not rely upon prices or costs in China in anti-dumping investigations of Chinese product. In response, China agreed in Article 15 of its Protocol of Accession to the WTO that allow countries to base dumping comparisons on alternative methodologies using something other than Chinese prices or costs. First, however, China committed under Article 9 of the Protocol to allow "prices for traded goods and services in every sector to be determined by market forces." If China fulfilled this obligation of Article 9, it would remove any doubt that Chinese prices and costs were a reliable basis for dumping calculations, so that the alternative methodologies allowed under Article 15 would not be necessary. Article 9 therefore creates the context within which Article 15 should be interpreted.

Article 15 of China's Protocol of Accession provides that the WTO Antidumping Agreement applies to dumping investigations of China, subject to the other provisions of Article 15. Under the WTO Agreement, WTO members are generally required to base dumping comparisons on the home market prices and costs of the individual producers of the product under investigation. Paragraph 15(a), however, states that WTO members may base dumping comparisons involving Chinese products on either Chinese prices or costs or using a methodology employing something other than domestic Chinese prices or costs. The latter approach is commonly referred to as "nonmarket economy country treatment," while the use of domestic prices and costs (the normal situation under the WTO Antidumping Agreement) is often termed "market economy treatment."

Under the WTO Antidumping Agreement, the investigating WTO member would normally make this decision – whether to base dumping comparisons on Chinese prices and costs or on something different – on a producer-by-producer basis. The subparagraphs of paragraph 15 establish two exceptions to this rule. Under subparagraph 15(a)(i), if the Chinese producers can show that an entire industry operates under market conditions, the investigating WTO member must use Chinese prices and costs for all dumping comparisons involving that industry, regardless of the experience of individual members. Subparagraph 15(a)(ii) establishes the converse – that if the Chinese producers cannot make such a showing, the WTO member can apply nonmarket economy treatment to the entire industry, regardless of the experience of individual producers.

Under the second sentence of Paragraph 15(d), the exception under subparagraph 15(a)(ii) expires on December 11, 2016. After that date, WTO members cannot automatically apply nonmarket economy treatment to an entire Chinese industry. The normal rules of treaty interpretation establish that this language must be interpreted according to the plain meaning of the words. This means that *only* subparagraph 15(a)(ii) expires in 2016. The language in the rest of Article 15 remains in effect.

When read in conjunction with the WTO Antidumping Agreement, the language of the chapeau authorizes the United States to continue to apply nonmarket economy treatment in antidumping investigations of Chinese products, but requires the United States to provide an opportunity for Chinese producers to show that they individually, as well as an industry, operate under market economy conditions. If a producer can make that showing, the United States would be required to use its domestic prices and costs. Under current U.S. law and procedure, individual Chinese producers already have this opportunity. Consequently, no change is required in U.S. law or practice after December 11, 2016.

Any interpretation of Article 15 as requiring market economy treatment for China after 2016 would have the perverse effect of rewarding China for not fulfilling its other obligations under the Protocol. It is clear that China has not satisfied this commitment, and that the Chinese government continues to assert control over prices in many different sectors of the Chinese economy through a variety of measures, as the Canadian authorities, for example, have repeatedly determined. Requiring other WTO members to use Chinese prices in dumping calculations, so allowing Chinese products to avoid the imposition of antidumping duties, would remove a major incentive for China to fulfill its commitments under Article 9.

The conclusion that the United States will be required to treat China as a market economy after December 11, 2016 is also contrary to the underlying purpose of Article 15. As noted above, Article 15 was put into place precisely because the Chinese government's influence over prices in China prevented those prices from serving as a reliable basis for dumping calculations. Forcing other WTO members to use Chinese prices and costs in dumping calculations would create exactly the situation the remaining provisions of Article 15 were intended to prevent.

Had the negotiating parties intended to require all WTO members to accord China market economy treatment after December 11, 2016, they could easily have done so by either specifying that outcome explicitly, or by requiring the expiration of Paragraph 15(a) in its entirety. Significantly, the Protocol does exactly this in the first sentence of Paragraph 15(d), which specifies that, if China establishes under the national law of another WTO member that it is a market economy, Paragraph 15(a) will be terminated with respect to that WTO member. Similarly, Article 16 of the Protocol of provided that the entire article would expire after 12 years. That the second sentence of Article 15 does not contain a similar provision is strong evidence that the parties who negotiated the Protocol did not intend for the entire paragraph to terminate in 2016, so that WTO members could continue to apply nonmarket economy treatment to China so long as they did so on an individual basis.

In sum, under existing U.S. law, the Commerce Department can determine whether individual Chinese industries or producers qualify for market economy treatment. The Commerce

Department can accord market economy status to some industries but not others. Under current U.S. law, both Chinese industries and individual Chinese producers are able to argue that they operate under market conditions, and are therefore entitled to the use of their domestic prices and costs in dumping comparisons. No changes in U.S. law are necessary to comply with the remaining requirements of the Protocol after December 11, 2016.

How Would Market Economy Status for China Affect the U.S. Economy?

If market economy treatment were extended to China, the Commerce Department would be required to use Chinese prices and costs. Because of the various ways in which the Chinese government intervenes in the economy, those prices and costs would generally be well below what they would be in a true market economy. As a result, dumping investigations of Chinese products would generally result in low or even zero margins.

A recent report entitled *Assessment of the Probable Economic Effects on NAFTA of Granting Market Economy Status to China* calculates that the extension of market economy treatment to China would result in a loss of up to 595,000 jobs in the United States.[4] Certain industries, including steel, would be especially affected. The report estimates that the extension of market economy treatment to China would result in a 10 percent decrease in U.S. steel production, and a decline in demand for American-made steel of more than $10 billion. Other industries would doubtless experience similar effects. David Autor of the Massachusetts Institute of Technology has recently published further evidence showing that, contrary to what was expected under classical economic theory, increases in imports from China have had lasting negative effects on employment in the United States, effects that reverberate through the entire U.S. economy.[5]

A decision by other countries to provide China with market economy treatment, for any reason other than that they have determined under national law that China is a market economy, would have significant negative effects for the United States. Because the Chinese government would be able to manipulate prices within China to avoid the imposition of antidumping duties, Chinese exports to countries granting it market economy treatment would almost certainly increase dramatically. Increased Chinese exports would negatively affect the U.S. economy in two ways. First, these exports would displace U.S. exports to the relevant countries. Second, countries subject to such an increase in imports from China would increase exports to the United States of products that could no longer compete against dumped (but unpenalized) imports in their home market. The end result would be a general deterioration of the world economy as China was able to compete on unfair terms.

This result would be amplified through various broad trade agreements, including the Trans-Pacific Partnership and the Transatlantic Trade and Investment Partnership. These agreements would allow China to dump products in foreign countries. Those products could then, through a variety of mechanisms, be re-exported to the United States and sold as products of the importing country. In this way, the treatment of China as a market economy by other countries would allow China to evade the dumping laws of the United States even if the United States

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[4] This report is available at http://www.steelnet.org/new/20151110a.pdf.

[5] D. Autor, D. Dorn and G. Hanson, The China Shock: Learning from Labor Market Adjustment to Large Changes in Trade, available at http://www.ddorn.net/papers/Autor-Dorn-Hanson-ChinaShock.pdf.

continued to consider China a nonmarket economy country. To prevent this outcome, the U.S. negotiators should insist that the TTIP include additional benefits for the United States sufficient to offset such an outcome should the EU grant market economy status to China.

Granting China market economy status would give it special and indeed unique treatment. The Chinese government could continue to influence or even set prices in a myriad of ways, so ensuring that Chinese products would be subject to low or even no dumping duties, regardless of their behavior. This would give China a huge advantage in international trade. It would also remove a major incentive for China to enact real market-based reforms. Such a result would be directly contrary to the intent underlying China's entire Protocol of Accession, in which China committed to allowing the market to set prices.

Conclusion

China is not a market economy. Whether the criteria considered are those under U.S., EU, or Canadian law, the results are the same. Nothing in the international obligations of the United States requires it to treat China as a market economy absent such a finding under national law. Treating China as a market economy when it is not one would have a significant negative impact on the U.S. economy, and would give China a strong and unearned advantage in international trade. It would remove a major incentive for China to implement market-based reforms, and allow it to ignore the commitments it made in its Protocol of Accession to allow prices to be set by market forces.

OPENING STATEMENT OF DR. ADAM HERSH
VISITING FELLOW, COLUMBIA UNIVERSITY

DR. HERSH: Thank you for inviting me back today to discuss China's nonmarket economy status under WTO rules. I'm going to just provide a cursory summary of how China has measured up to the various criteria. I go into much more detail on that in the written testimony that I submitted, but I want to focus particularly on the concerns that China's nonmarket economy status raise as pertains to the risks if the United States is to enter the Trans-Pacific Partnership Trade and Investment Agreement and the U.S.-China Bilateral Investment Treaty, which is under negotiation.

But I want to start by noting that it's important to recognize that even in market economies, market economies exhibit significant roles for government action, not all government action is economically undesirable, and China's economy has evolved considerably since joining the WTO in 2001.

Thus, I would more neutrally characterize China as an economy still in transition from central planning and administration. It's important that we take a functional view of China's economy, not hold it accountable to some idealized textbook model of what an economy is.

Still we can look within the statutory factors defining in law what a market economy is and in each of these areas see areas that have shown much progress as well as much regress away from the standards, as I do in my written testimony. And I'll note also that other countries that have enumerated these statutory criteria for a market economy all converge on a similar set of factors.

What clearly distinguishes the structure and institutions of China's economy from others is how economic choices and allocation of resources continue to be guided by factors other than market prices and economic viability of individual firms. This is certainly true for state-owned segments of the economy, which have grown in terms of national investment and employment since 2001, and it is also true for key prices affecting all agents in the economy. Interest rates and the exchange rate, just to name two.

Thus, it is difficult to divorce emerging private sector enterprises from the influences and privileges of government policy and economic strategy in China. I would also note that many of the issues raised in the 2001 WTO Working Party Report before China acceded to the organization still feature as sticking points in the bilateral economic relationship today.

The nonmarket economy criteria are derived from economic first principles. They are not designed foremost to protect U.S. jobs and businesses. They are designed to protect against the general social welfare losses from such economic inefficiencies that a non-market economy creates.

There have no doubt been significant costs to the United States from offshoring and import competition, playing on a slanted field with China's nonmarket actors. But it's also true that Chinese people have borne a significant share of these real economic costs from things like toxic air, water, food, and consumer products, repression of wages and consumption, constraints on growth and innovation in private economic activity.

These costs all weigh on the Chinese people and China's national development, and they are why we now see the people who profited most from these arrangements seeking to move their families from China to other places around the world.

So what concerns should this raise for U.S. policymakers? First, policymakers need to ensure that U.S. government retains and uses all available tools under U.S. law and WTO rules for trade enforcement. Not only do these rules help ensure a level playing field for international competition, but they also create incentives for China's policymakers to change their practices that distort global markets and create steep costs to social welfare.

Second, members of Congress should look carefully at the implications of the Trans-Pacific Partnership for strengthening China's economic position. Although proponents present the TPP as an answer to China's rising regional influence, if you actually read and understand the agreement, you'll see the incredibly weak rules of origin actually create a backdoor for content from outside the TPP region from China and other countries to gain preferential treatment in TPP markets.

Under these rules, more than 90 percent of the value can come from outside TPP and still qualify for benefits under the agreement without committing to the agreement's other standards or making reciprocal market opening.

TPP partners--Australia, New Zealand, Singapore, and Malaysia--have already promoted China to market economy status under WTO rules, meaning that with TPP, Chinese content produced on a nonmarket basis will gain free entry to the U.S. market. Rather than countering China's weight, TPP will serve as a Trojan Horse for goods produced in China.

Third, members of Congress should also look carefully at the bilateral investment treaty currently being negotiated by USTR and China. If the USTR follows the same investor dispute model as in TPP and other past U.S. agreements, the U.S.-China BIT will give American multinationals new rights and powerful means to undermine government actions in China that could actually prevent China from raising its own standards on labor rights, pollution control, public health and consumer safety, as they have under other agreements. This would make it easier and more attractive for multinationals to move investments offshore and make it harder for China to meet the standards of international commercial competition.

The investment dispute mechanism is also a two-way street, meaning that Chinese enterprises that are expanding their overseas investment footprint in the United States will gain a much more favorable mechanism to challenge policies of the federal, state and local governments here in the United States. As China's economy has developed, so too has its willingness and ability to bring trade disputes under the WTO, and we should expect that that will apply equally to the bilateral investment treaty.

Rather than continuing with the problematic investment dispute model, members of Congress should press USTR to consider different approaches to ensuring national treatment of foreign investors in these agreements.

Thank you.

PREPARED STATEMENT OF DR. ADAM HERSH
VISITING FELLOW, COLUMBIA UNIVERSITY

Testimony before the U.S.-China Economic and Security Review Commission on China's Shifting Economic Realities and Implications for the United States

Dr. Adam S. Hersh, Ph.D.
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Co-chairs, members of the Commission: thank you for inviting me to testify today on China's Shifting Economic Realities and Implications for the United States, particularly as it pertains to China's nonmarket economy (NME) status under World Trade Organization (WTO) rules.

This testimony will assess China's reform progress towards the market economy statutory criteria as well as highlighting concerns that China's still nonmarket economy—in particular through the back door for Chinese imports created by the Tans-Pacific Partnership's loose "Rules of Origin" and the risk of providing state-controlled enterprises with access to investor dispute settlement under the proposed U.S.-China bilateral investment.

It has been nearly 15 years since China acceded to the WTO. China's accession agreement classified it as a "nonmarket economy," a designation that recognized China's unique economic institutions deserved special consideration for enforcing a level commercial playing field in the rules-based international trade and finance system. China's accession agreement allowed WTO members to define criteria for how and when a country could be considered a market economy. [1]

U.S. law in particular specifies the following six factors, although most countries adhere to a similar set of criteria:

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

Despite independent processes, countries converged on a common set of criteria, based on economic first principles, which define core institutions of a market economy. Economists might more neutrally classify China as a "still transitioning economy" rather than a "nonmarket economy." This is consistent with the dramatic transformation in China's economic structure from the centrally planned and administered economy left behind in 1978 to the not yet fully

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[1] Additionally, just prior China's December 2001 accession, representatives of China's government and those of other WTO members released a final Working Party Report—the product of 14 years of multilateral dialogue—also detailed specific problematic policies and practices as well specific remedies and timetables pledged by China's policymakers upon accession. World Trade Organization, *Report of the Working Party on the Accession of China WT/MIN(01)/3*, November 10, 2001.

transformed economy that we see today.

To be certain, even "market economies" exhibit significant roles for state action and intervention. However, what distinguishes NMEs is that, by design, they allocate resources and make economic choices based on factors other than market prices and economic viability. Thus, the transaction prices observed in NMEs don't necessarily reflect the normal value of goods. In particular, NMEs may directly or indirectly subsidize producers by creating the conditions to underprice the costs of an economy's factors of production—money for investment, energy and raw materials for industry, and even people for work.

Much has changed in China and the world economy over this time. When China joined the rules-based international trading system, roughly two-thirds of it's population still lived in poverty, it's economy was one-third the size of the United States, and the world was still six years away from seeing the first iPhone.[2] Today, China's economy is the second only to the United States in size, it is the world's largest trader and source of foreign direct investment, and its economic growth in this time has lifted close to 500 million of its people out of poverty.

A stable and prosperous China is of benefit to the world, but this does not mean that accommodation of China's nonmarket economy within the global trade system has been all benefit and no cost. MIT economist Daron Acemoglu and co-authors estimate that import competition cost the United States as many as 2.4 million jobs in the first decade to the 21st Century.[3] The shock affects not just those employed directly in import-competing industries, but spills over to suppress employment and wage growth and to burden public budgets across entire regional economies.[4] The U.S. trade deficit with China has expanded to 50 percent of a growing total U.S. trade deficit in 2015 from 20 percent in 2001.[5]

The NME measure was designed not just—or even primarily—to protect U.S. jobs and businesses. They are designed to protect against the general social welfare losses that occur from such inefficient economic choices. These choices have allowed real economic costs like toxic air, water, food and consumer goods; wage repression; and constraints on growth and innovation in private economic activity to weigh on Chinese people and China's national development.

This testimony begins with an overview of the recent trends in economic policymaking since China joined the WTO, evaluates China's progress towards market economy criteria, and concludes with concerns for U.S. policymakers from China's still transitioning economic structure.

2. China's progress toward the market economy criteria

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[2] Measured at the World Bank's international poverty line of US$3.10 per day (2011 PPP), available at World Bank *World Development Indicators Database*, http://databank.worldbank.org/data/reports.aspx?source=world-development-indicators; Gross domestic product based on purchasing power parity, available at IMF *World Economic Outlook Database*, http://www.imf.org/external/pubs/ft/weo/2012/02/weodata/index.aspx.

[3] Acemoglu, Daron, David Autor, David Dorn, Gordon Hanson, and Brendan Price, "Import Competition and the Great U.S. Employment Sag of the 2000s," *NBER Working Paper No. 20395*, August 2014. http://www.nber.org/papers/w20395.

[4] Autor, David H., David Dorn, and Gordon H. Hanson. 2013. "The China Syndrome: Local Labor Market Effects of Import Competition in the United States." *American Economic Review*, 103(6): 2121-68.

[5] Analysis of U.S. Census Foreign Trade, "U.S. Trade in Goods by Country," available at https://www.census.gov/foreign-trade/balance/index.html.

China's economy is certainly not the same as it was when it first joined WTO in 2001. Rapid growth propelled China on the path to become the world's largest economy and trading nation. China's technological sophistication in China's economy advanced rapidly with substantial investments to expand its indigenous capacity along with learning from investment from multinational enterprises that relocated first production and later research and development activities to China's shores.

Metrics and rankings favored by the popular press often give a misleading impression that China is nearing a market-based economy. For example, China boasts 106 companies in the ranks of the 2015 *Fortune* Global 500 .[6] Of China's 596 billionaires (in dollar terms), 242 reached that status in 2015.[7] Chinese consumers crave international luxury goods with perhaps even greater fervor than consumers elsewhere in the world.[8] Chinese companies have set successive records for largest initial public offering, or IPO, most recently with e-commerce giant Alibaba's 2014 offshore listing in the United States, the largest in history on the New York Stock Exchange.[9]

Such stylized and anecdotal facts can be misleading. It is necessary to make a more systematic evaluation of the empirical evidence and institutional changes in China's economy since 2001. While investment, exports, and individual fortunes have certainly surged ahead in the 2000s, and while this prosperity derived from the combination of new foreign market access and export-oriented growth policies, the overall evidence assessed in each of the market economy criteria areas reveals that despite many areas of progress, key features of China's NME remain intact.

Following China's WTO entry, it is widely understood that the leadership of Hu Jintao and Wen Jiabao had moved China's economic development increasingly in a state-centered direction. In the words of political scientist Minxin Pei, this is when "China's reform died… so much for the prognostication that WTO accession would spur reform."[10] The rebound of the state was so universally obvious after 2001 that native speakers coined a new idiom to describe the phenomenon: "guo jin min tui," or, "the state advances while the private sector retreats," a play on Jiang Zemin's market reform slogan from the 1990s.[11]

When Xi Jinping and Li Keqiang took office in 2012, they pledged a new dawn of reform in China's long arc of economic transition that would course correct from the previous ten years and put China back on the path away from central planning and towards a greater role of market mechanisms and the private sector. The Party's 3rd Plenum Decision in October 2013 outlined a call for reform heretofore unparalleled in ambition of scope.[12] It is worth noting that, even if fully

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[6] EL Borromeo, "More Chinese Firms Make It to Fortune Global 500 List," *Yibada*, July 25, 2015, available at http://en.yibada.com/articles/48237/20150725/more-chinese-firms-make-fortune-global-500-list.htm.
[7] "Robber Barons, Beware," *The Economist*, October 24, 2015, available at http://www.economist.com/news/china/21676814-crackdown-corruption-has-spread-anxiety-among-chinas-business-elite-robber-barons-beware.
[8] "China: Beyond Bling," *The Economist,* December 13, 2014, available at http://www.economist.com/news/special-report/21635763-tastes-are-changing-appetites-remain-keen-beyond-bling.
[9] "A Look Inside the Biggest IPO of All Time," available at https://www.nyse.com/network/article/Alibaba-Lists-on-the-NYSE (last accessed November 2015).
[10] Adam S. Hersh, "Assessing China's Economic Reform Agenda" (Washington: Center for American Progress, 2014), available at http://cdn.americanprogress.org/wp-content/uploads/2014/04/ChinaReformBrief.pdf.
[11] Chen Li, *China's Centralized Industrial Order: Industrial Reform and the Rise of Centrally Controlled Big Business*, (London: Routledge, 2014).
[12] The Third Plenum decision, although primarily economic policy focused, also addresses a number of issues of broader social and political reform. See also: Adam Hersh, "Assessing China's Economic Reform Agenda;" "Decision of the Central Committee

implemented as articulated in the Decision and with the further detail provided in subsequent policy announcements, reforms would still leave China's economy short of the market economy criteria and with a substantial role for government control unparalleled in other WTO member countries.

Not only are the market economy criteria enumerated by China's WTO partner countries derived from economic first principles, but a WTO Working Party comprised of representatives China's government and other representative governments meeting 14 times reviewed in nearly 200 pages of detail specific policies and practices that WTO members saw as violating the conditions of commercial fair play, as well as the specific steps China's policymakers pledged to take to remedy these upon accession. [13] This included issues like: trade distorting subsidies and industrial policies, non-commercial lending terms, failure to adequately make subsidy disclosures, technical barriers to trade, investment restrictions and conditionality, unfair commercial use and disclosure of test and regulatory data, use of offset arrangements in aerospace and other advanced technology manufacturing, and commitment to enforcing intellectual property rights. As the Commission is well aware, these and more are issues that continue to be sticking points in the U.S.-China relationship.

2a. Government ownership and control of the means of production

China's economy has changed in many sensible ways, yet its political institutions have lagged behind. University of Chicago political scientist Yang Dali describes the extent of state involvement, virtually ubiquitous across most dimensions of economic activity:

> "It was not just government departments that engaged in business dealings. The military, the police, and the courts, indeed just about any party and state agency that could convert its power, assets, and privileges into lucre, were running business operations."[14]

In the assessment of Professor Yang, full transition for China's economy requires not only "introduction of markets, but also the rebuilding of the state into one that is qualitatively different and suited to markets…the state [must] retreat in some areas of the economy, change its behavior in others, and build and rebuild the institutions and capacity to govern markets and provide various forms of public goods." [15]

What matters—from an economic perspective—is who holds agency over China's economic resources, and what incentives and constraints these people face in making economic decisions? The same groups of people hold the same policy levers and face the same set of incentives. They occupy positions of controls over China's productive and financial resources and are linked together through formal and informal networks that allow coordination of activities across discrete institutions.

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of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform," available at http://www.china.org.cn/china/third_plenary_session/2014-01/16/content_31212602.htm (last accessed November 2015).

[13] World Trade Organization, *Report of the Working Party on the Accession of China WT/MIN(01)/3*, November 10, 2001.

[14] Dali Yang, *Remaking the Chinese Leviathan: Market Transition and the Politics of Governance in China* (Stanford University Press: 2004).

[15] Dali Yang, *Remaking the Chinese Leviathan: Market Transition and the Politics of Governance in China* (Stanford University Press: 2004).

The WTO defines government ownership or control of the means of production to comprise a public body, "an entity that possesses, exercises, or is vested with governmental authority."[16] This means that a government exercises meaningful control over an entity and that this entity may be used in certain circumstances to serve or exercise governmental authority. WTO rulings currently measure a public body according to a five-factor test that includes: [17]

- Government ownership
- Government presence on the board of directors
- Government control over activities
- Pursuit of governmental policies or interests
- Whether the entity was created by statute

The US has argued for a different definition of public body as an "entity controlled by the government such that the government can use the entity's resources as its own."[18] WTO Subsidies and Countervailing Measures Article 1.1(a)(1) discusses "a government ***or any*** public body." Therefore, the "or" suggests that a public body encompasses a broader meaning than just a body of the government, and "any" means there may be different types of public bodies. Government control and ability to use resources is the "unifying characteristic" of all types of public bodies. Some might have governmental authority, but others may not.

This latter standard is perhaps more appropriate to the case of China's economy considering the myriad forms of state ownership and channels of state involvement that have and continue evolving in China's transition away from central planning.

Economic theory recognizes multiple dimensions of property rights. These include:

1. The right to control a good or assets.
2. The right to collect income flows from use of the good or asset.
3. The right to sell buy and sell assets (alienability right)

A simple look at the data reveal the trend since WTO accession in China has actually been to expand assets in the economy where property rights fell to government control, not an expansion of the private sector. Figure 1 shows the growth of fixed asset investment in China by ownership form, adjusted for inflation. State-involved enterprises, encompassing all forms of state-owned enterprises as well as joint ventures with majority state-owned partners, grew apace with investment in domestic-owned private enterprises in China in the late 2000s and into the 2010s. The effects of China's response to the Great Recession—fiscal stimulus and monetary easing—can be seen in the bubble of state-involved enterprise investment in 2009 and 2010, not mirrored by private investment trends.

More surprisingly, given the seeming deep integration of major global businesses in China's

[16] World Trade Organization, "United States – Definitive Anti-Dumping and Countervailing Duties on Certain Products from China: Report of the Appellate Body," (Geneva: World Trade Organization, 2011), p. 122, available at http://www.wto.org/english/tratop_e/dispu_e/379r_e.pdf.

[17] World Trade Organization, "United States – Definitive Anti-Dumping and Countervailing Duties on Certain Products from China: Report of the Appellate Body," p. 133.

[18] United States Trade Representative, "United States – Countervailing Duty Measures on Certain Products from China (DS437): First Written Submission of the United States of America," March 15, 2013, available at https://ustr.gov/sites/default/files/USSub1.Final%20For%20Posting.pdf.

domestic economy, investment from foreign owned companies (not in joint venture with state-owned enterprises) remains less than 2 percent of total business investment in China—about half of foreign investment in China is registered to Hong Kong, Macau, and Taiwan companies, of which economists estimate that as much as half of this may actually be domestic capital, laundered abroad in order to qualify for preferential policies or to shelter assets.[19]

Similarly, state-owned enterprises also comprise an increasing share of employment since 2002, as seen in Figure 2, reversing course on what has been overall a decline since in state enterprise employment since the early 1990s. The biggest changes in China's labor market have been the shift of employment out of agriculture and into businesses registered as private owned, self-employment, or other unspecified forms of ownership. The share of Chinese people working in agriculture fell from 50 percent in 2000 to 31 percent in in 2013, while the share working in the private sector rose from 13 percent to 43 percent.

The shift out of labor employment is well known and widely recognized as contributing significantly to China's increase in overall economic productivity and broad increase in living standards. It is less widely understood that in fact employment in state-owned enterprises also expanded as a share of the economy—those owned by government entities at the central, provincial, and local levels. Between 2000 and 2011, employment in state-owned enterprises grew from 33 percent of all employment in China to 37 percent. Following 2011, official statistics do not report observations for the full range of ownership forms, but assuming proportional growth, state-owned enterprise would account for well over 40 percent of all jobs in China today. This expanding of state employment does not reflect the surplus labor long-since shed from official payrolls, but rather the real expansion of the footprint as enterprising managers learn to effectively capitalize on the incentives provided in China's economic system. At the same time, Figure 2 shows that wholly-private foreign direct investment in China, though increasing to 4 percent today from less than 1 percent in 2000, still registers only a minor share of overall employment.

Public officials, not shareholders, continue to select the top managers and members of boards of directors of China's major and minor corporations including most state-owned and many privately owned firms.[20] High ranking employees often hold positions of power simultaneously in government institutions, within the party, and on boards of related enterprises.[21] Senior managers of central SOEs—the 117 enterprises controlled by China's State-owned Asset Supervision and Administration Commission, commonly referred to as SASAC—hold the equivalent of senior minister-level status in China's political system and run some of the world's largest corporations. Political scientist Minxin Pei estimates that the Chinese Communist Party appoints four-fifths of the chief executives at SOEs and more than half of all senior executives.[22]

A systematic rotation of high level people among corporations, government, and the Communist party enables planning and coordination for these separate entities.[23] Executive musical chairs is a

[19] http://www.oecd.org/china/WP-2013_1.pdf; http://www5.iadb.org/laeba/downloads/WP_24_2004.pdf; https://www.imf.org/external/pubs/ft/pdp/2002/pdp03.pdf;
[20] Adam S. Hersh, "Assessing China's Economic Reform Agenda," p. 12.
[21] Ibid., p. 13.
[22] Minxin Pei, "The Dark Side of China's Rise," *Foreign Policy*, October 20, 2009, available at http://foreignpolicy.com/2009/10/20/the-dark-side-of-chinas-rise/.
[23] Li-Web Lin and Curtis J. Milhaupt, "We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in

common occurrence. For example, leaders in three of China's top telecommunications SOEs swapped places in 2007.[24] In holding multiple positions within firms and government simultaneously, senior officials are constantly rotating through various positions, allowing them to easily collaborate strategy and activities, and to develop experience and relationships to proactively solve problems. By 2003, 34 percent of private entrepreneurs were CCP members, compared to 14 percent a decade earlier. Membership is a valuable asset, and is associated with private entrepreneurs' ability to gain access to bank credit.[25]

Increasingly, such enterprises have transitioned to apparently modern corporate governance structures with extensive families of corporate subsidiaries. [26] As a recent editorial in *Caixin* magazine—comparable to *The Economist* of China—observed:

> Nowadays, many state firms are undertaking shareholding reforms, and many have become listed companies. However, since state shareholders have absolute control of these firms, there has been no marked improvement in their governance structure.[27]

Unfortunately, the challenge of divorcing the state from the levers of economic control remains daunting to both domestic and international experts. Legal institutions necessary for the micro-market structure necessary to rely on market mechanisms for aligning manager and owner incentives for governance of the firm do not exist in China. [28] Even where public listings sell shares to private investors, Chinese laws and regulations constrain the control that shareholders can exercise over management. This is a somewhat moot point because only non-controlling minorities of shares are ever in play in China's stock markets. As a result, the market can do little to weigh in when it comes to choosing firm managers and boards of directors—positions appointed by party personnel systems.

Officials often serve simultaneously as the policymaker and regulator, combining direct or indirect ownership interests in enterprises over which they govern. In a true market economy, CEOs face the risk of dismissal if the company's financial performance under their management sufficiently disappoints investors, leading to sagging stock prices. In China, by contrast, with a minority of shares offered to public trading, and with basic legal institutions that restrict the voice and protections of shareholders, senior managers of state-involved firms are largely insulated from the possibility that independent investors could challenge control of the enterprise.

Government control is particularly prevalent in China's financial system where, the U.S.

China," Stanford Law Review 65 (4) (2013): 697–760, available at http://www.stanfordlawreview.org/print/article/we-are-national-champions

[24] Nicholas Howson, "China's Restructured Commercial Banks: Nomenklatura Accountability Serving Corporate Governance Reform." In Martha Avery, Zhu Min, and Cai Jinqing, eds., China's Emerging Financial Markets: Challenges and Global Impact (Singapore: John Wiley & Sons, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1351853.

[25] Kellee S. Tsai, *Capitalism without Democracy: The Private Sector in Contemporary China* (Cornell University Press, 2007), p. 83- 84.

[26] Li-Web Lin and Curtis J. Milhaupt, "We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China," Stanford Law Review 65 (4) (2013): 697–760, available at http://www.stanfordlawreview.org/print/article/we-are-national-champions

[27] Caixin, "SOE Reform Needs Examples More than Policies," April 2, 2014, available at http://english.caixin.com/2014-04-02/100660225.html.

[28] Zhong Zhang, "Legal Deterrence: The Foundation of Corporate Governance—Evidence from China," available at http://policydialogue.org/files/events/Zhang_Zhong_Legal_Deterrence.pdf (last accessed November 2015).

Department of Commerce notes, "near complete state-ownership of the banking sector in China" has functioned to deliver impermissible subsidies to favored companies in carrying out official policy through the banking system.[29] Article 34 of China's Commercial Banking Law states that banks must "carry out their loan business upon the needs of [the] national economy and the social development and under the guidance of State industrial policies."[30] In the prospectus for its global sharing offering, Bank of China was required to disclose the risk to potential investors that: "Chinese Commercial Banking Law requires commercial banks to take into consideration government macroeconomic policies in making lending decisions." [31] As the OECD finds, the chief executives of China's state-owned commercial banks, or SOCBs, are government-appointed and "the party retains significant influence in their choice" despite corporate governance reforms and public share offerings.[32]

In fact, the state directly owns the vast majority of the country's financial institutions, and it is also the largest actor in China's financial markets. Banks, brokerages, insurance, and investment firms, the majority of corporate shares in publicly listed companies, financial assets in bonds, derivatives, and foreign exchange markets are largely under China's control.[33] Many of the nonmarket distortions pervasive in China's financial system are baked into the cake by the extent of state involvement in financial institutions and its control over nonfinancial corporations. That is to say, financial markets in China cannot operate like financial markets in other developed economies in the following aspects:

- Pricing and allocating capital based on economic risk assessments
- Providing a market for corporate control and a price signal to guide firm managers' performance
- Providing an opportunity to participate in control over firms, including governance and ownership decisions
- Paying income shares to firm owners

The state institutions that control China's financial system preclude the functioning of market-based mechanisms that typically serve these roles in other non-state-driven advanced and developing economies. Instead of two parties engaging in a business relationship, it is two parts of one party in the form of the Chinese government. If the state is party to both sides of transaction, market forces cannot determine capital prices. Domestically-funded financial institutions receive exclusive benefits from liberalization reforms and will continue to be able to offer non-bank financial products like auto loans, trust and asset management, and leasing services on non-

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[29] Yi Laio, "Whether China's State-Owned Commercial Banks Constitute 'Public Bodies' within the Meaning of Article 1.1 (a) (1) of the Agreement on Subsidies and Countervailing Measures: Analysis of US—Definitive Anti-Dumping and Countervailing Duties on Certain Products from China", *Beijing Law Review* 4 (4) (2013): 198-218.

[30] The Role of Law and Regulation in Sustaining Financial Markets (Philipsen, Xu, 2013), Chapter 5.3.5

[31] World Trade Organization, "United States – Definitive Anti-Dumping and Countervailing Duties on Certain Products from China: Report of the Appellate Body," March 11, 2011, available at http://www.wto.org/english/tratop_e/dispu_e/379r_e.pdf.

[32] Organization for Economic Cooperation and Development, "Economic Survey of China" (2005) 140-141.

[33] Carl Walter and Fraser Howie, Red Capitalism: The fragile financial foundation of China's extraordinary rise (Singapore: Wiley and Sons, 2011)

commercial terms. [34]

Reform plans are underway for state enterprises in both the real and financial sectors of China's economy. In the real sector, pilot state-owned enterprise reforms call for a "mixed ownership economy" that will allow foreign and private investors to invest in Chinese SOEs but only on a minority basis.[35] The directive is not entirely a shift toward market economy standards. At the same time it lets foreign investors in, other parts of the directive prescribe that state capital should maintain "the absolute controlling position" of the economy and consolidate state assets under complex-corporate structures. None of these signs point to a loss of state control, but rather allow key foreign business interests an opportunity to buy a limited share in China's economic machine.

In the financial sector, pilot reforms to open China's financial system to private banking will be limited to four different models targeted to test the waters in segments of the banking system underserved by current institutions, though all the private investors approved for new ventures all exhibit strong state ties.[36] The first pronouncement on the private banking experiments indicated that new ventures would be required to draw up "living wills"—plans for unwinding an institution's financial commitments in the event it becomes insolvent.[37] The focus on creating a mechanism to insulate public exposure to private risk-taking was ostensibly a lesson that China's leaders and financial regulators drew from watching their U.S. counterparts scramble in 2008 to cope with the collapse of Lehman Brothers investment bank and insurer American International Group.

In July 2014, the China Banking Regulatory Commission announced that it would require contingent capital arrangements to ensure sufficient funding is available following unexpected adverse events. Both owners and investors would be exposed to risk that should theoretically reintroduce discretion into the investment process.[38] According to *The Economist*, it would work as "debt issued by a firm that could be converted into equity during a period of financial stress" to guarantee capital liquidity.[39] Reforms rolling out in China's experiments in the Shanghai Free Trade Zone and other newer free trade zones will require new banks to be controlled or founded by a Chinese national and can only implement models based on Internet-based micro-lending, corporate banking, private banking, or other unspecified activities.[40] Still, the SFTZ allows for new finance opportunities in commodities, supply chain, asset management, and international investment.

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[34] Deloitte, "Circular of China Banking Regulatory Commission on Issues Concerning Banking Supervision in China (Shanghai) Free Trade Zone" (2013), No. 40, available at http://www2.deloitte.com/content/dam/Deloitte/cn/Documents/tax/shanghai-pilot-free-trade-zone/regulations/deloitte-cn-tax-shpftz-cbrc-en-zh-241013.pdf

[35] *Xinhua*, "China urges SOE modernization through mixed ownership reform," September 24, 2015, available at: http://english.gov.cn/policies/latest_releases/2015/09/24/content_281475197422388.htm; http://www.gov.cn/zhengce/content/2015-09/24/content_10177.htm.

[36] Adam Hersh, "Assessing China's Economic Reform Agenda", (Washington: Center for American Progress, 2014), available at http://cdn.americanprogress.org/wp-content/uploads/2014/04/ChinaReformBrief.pdf.

[37] "China Approves Trial for Five New Privately Owned Banks," *Bloomberg News*, March 11, 2014, available at http://www.bloomberg.com/news/articles/2014-03-11/china-approves-trial-for-five-new-privately-owned-banks.

[38] Chinese Banking Regulatory Commission, "IRB Approach: Supervisory Requirements on Risk Mitigation" (2012), available at http://www.cbrc.gov.cn/chinese/files/2013/E5623422085F456F83B43AE2E5C6561E.pdf.

[39] "The advantages of contingent capital," *The Economist*, October 14, 2009, available at http://www.economist.com/blogs/freeexchange/2009/10/the_advantages_of_contingent_c.

[40] Wu Hongyuran, "Private Banks in Pilot Will Have Four Models to Choose From," Caixin, March 12, 2014, available at http://english.caixin.com/2014-03-12/100650585.html.

2b. Currency convertibility and exchange rate management

The most dynamic area of economic reform in China pertains to management of the exchange rate and inextricably related issues of capital market and interest rate liberalization. This is because effective pricing of the exchange rate by market mechanisms requires that investors formulate clear expectations about the term structure of interest rates—that is, what interest rates are charged for different levels of risk and for different lengths of time. The interest rate term structure defines the price of money, and therefore the level at which it should exchange with other national currencies given the interest rate term structure and price levels in those other monies. As Eswar Prasad reported to this Commission, the sequencing of capital market reforms are paramount to the success of an exchange rate reform, however the extensive state ownership and control over capital allocation and pricing present significant barriers to establishing a market-based exchange rate mechanism in China.[41]

China's currency is and for a long time has been freely convertible for trade transactions, but convertibility is still regulated for financial transactions. After a decade of managed appreciation of the China's renminbi, or RMB, against the U.S. dollar, China's monetary authorities once again intervened causing a nearly three percent devaluation over three days in August 2015.[42] As the dollar had appreciated against world currencies—thanks to the ongoing economic stagnation and debt crises in Europe, competitive devaluations from countries like Japan, Singapore, and Malaysia, and expectations of a Fed interest rate hike—China's currency, still pegged to the dollar, appreciated and lost international competitiveness, too.

China's monetary authorities and the IMF declared this move as a step on the road toward eventual liberalization of the exchange rate to a completely market-based mechanism.[43] Premier Li Keqiang, the economist, had said in his 2014 Report on the Work of government and the economic reforms which he was crafting, "We will keep the RMB exchange rate basically stable at an appropriate, balanced level, expand its floating range, and move toward RMB convertibility under capital accounts."[44] PBOC Governor Zhou Xiaochuan explains China's exchange rate mechanism as "a managed floating exchange rate regime based on market supply and demand and with reference to a basket of currencies."[45]

However, much uncertainty remains over how far and how fast this reform may proceed, particularly given the financial market disruptions and capital outflows experienced in China over the past year. Other statements by Governor Zhou underscore plans to ease its foreign exchange activity will preserve the capacity to intervene in the market depending on the situation.[46] In a

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[41] Prasad, Eswar, "China's Efforts to Expand the International Use of the Renminbi," February 4, 2016. http://origin.www.uscc.gov/sites/default/files/Research/China's%20Efforts%20to%20Expand%20the%20Internationalization%20of%20the%20RMB.pdf.

[42] Phillip Inman, "China Ends Three Days of Yuan Devaluation," *The Guardian,* August 14, 2015, available at http://www.theguardian.com/business/2015/aug/14/china-halts-yuan-devaluation-with-slight-official-rise-against-us-dollar.

[43] Sophia Yan, "IMF: China's Currency Reforms Are a Good Thing," *CNN Money,* August 12, 2015, available at http://money.cnn.com/2015/08/12/news/economy/china-imf-yuan/.

[44] Premier Li Keqiang, "Report on the Work of the Government," Testimony before the Second Session of China's Twelfth National People's Congress, March 5, 2014, English translation available at http://news.xinhuanet.com/english/special/2014-03/14/c_133187027.htm.

[45] "Transcript of Governor Zhou Xiaochuan's Exclusive Interview with Caixin Weekly," February 14, 2016. http://www.pbc.gov.cn/english/130721/3017134/index.html.

[46] Bloomberg News, "PBOC will 'Basically' End Normal Yuan Intervention: Zhou," Bloomberg, November 19, 2013, available

recent interview, Zhou said, "Our aim is to have the exchange rate 'broadly stable at an adaptive and equilibrium level.'"[47] Stability and market-based exchange rate pricing do not go hand-in-hand. Indeed, market-based exchange rates have proven more volatile than managed exchange rates across developing and developed countries in the period following the breakdown of the Bretton Woods fixed exchange rate system.[48]

Managing exchange rates also comes with potential costs and risks, but at the present time moving to a market-based exchange rate would certainly exacerbate many of China's macroeconomic problems—particularly debt sustainability and inflationary pressures—while also leading to a sharp depreciation that will worsen China's current account balances with trading partners. But a full liberalization does not seem to be what Gov. Zhou or Premier Li are suggesting—they are indicating that policy management of the exchange rate will continue to define the Renminbi for the foreseeable future.

Statements on the direction of exchange rate reform also reference reliance on a basket of currencies against which the value of the Renminbi will be managed. This is not a new policy, but continuation of a policy announced in June 2005, when policymakers began managing the gradual appreciation of the Renminbi against the dollar. A key question here is against which currencies will the Renminbi be managed? Econometric analysis is helpful in illuminating the composition of the currency basket targeted by monetary policymakers, following a widely-used method developed by Harvard economist Jeffrey Frankel and former IMF economist Shang-Jin Wei to measure the relative flexibility of a currency and how heavily an exchange rate is pegged to other international currencies.[49] This is accomplished by evaluating how China's and other countries' exchange rates co-vary relative to another benchmark rate—in this case, SDRs, while also accounting for monetary pressure building in the financial system due to a misaligned exchange rate peg.[50] Frankel and Wei's method also allows the analysis to account for monetary pressure building up in the financial system due to an exchange rate peg. The results of this analysis are presented in Figure 3. Beyond just looking at one point in time, Figure 3 shows the results of estimating the currency weights using higher frequency daily data in rolling 180-day windows. This provides a clearer picture of how China's exchange rate peg has evolved over time—or in this case has not changed.[51]

Surging exchange market pressures create small spikes and valleys in the estimated basket weights—most notably for the speculative bubble years that preceded the 2007–2008 global financial crisis. When the crisis hit, capital controls bound tighter, and China reverted back to a near-100 percent peg to the U.S. dollar. This worked for a while, but China's capital controls soon saw more pressure. This was due to a rising tide of capital in international financial markets—

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at http://www.bloomberg.com/news/2013-11-19/pboc-will-basically-exit-normalyuan-intervention-zhou-says.html.

[47] "Transcript of Governor Zhou Xiaochuan's Exclusive Interview with Caixin Weekly," February 14, 2016. http://www.pbc.gov.cn/english/130721/3017134/index.html.

[48] Yin-Wong Cheung, Menzie D. Chinn, and Antonio Garcia Pascual, "Empirical Exchange Rate Models of the Nineties: Are Any Fit to Survive?" Working Paper 04/73 (International Monetary Fund, 2004), available at https://www.imf.org/external/pubs/cat/longres.

[49] Jeffrey Frankel and Shang-Jin Wei, "Estimation of De Facto Exchange Rate Regimes: Synthesis of the Techniques for Inferring Flexibility and Basket Weights," IMF Staff Papers 55 (3) (2008): 384–416.

[50] International Monetary Fund, "IMF Exchange Rates Country Database," available at http://www.imf.org/external/np/fin/ert/GUI/Pages/CountryDataBase.aspx (last accessed August 2014).

[51] Data and program are available from the author upon request.

enabled in part by successive rounds of quantitative easing of monetary policy from the Federal Reserve, as well as by the large gap between potential returns on dollar and RMB assets.[52] The analysis shows an ongoing shift away from the U.S. dollar as the sole currency in the exchange rate basket. The Singapore dollar, and the Euro have been the main currencies added into the mix, but the dollar still maintains its role as predominant currency in China's basket, explaining roughly 90 percent of the RMB's exchange rate.

2c. Government control over allocation, pricing, and production

Since 2001, in compliance with WTO commitments, China abolished some 124 price regulations.[53] Many prices in China's economy operate on conditions of supply and demand—particularly for consumer goods and services—where high output and economies of scale in production can drive prices down and help raise real consumption. Many key prices remain state-influenced, including prices in financial markets, land markets, and key raw materials and intermediate goods that feed into other industries in China's economy. These hold down the prices of key inputs for China's industries, providing cost advantages in specific industries and more generally economy-wide.

Market price determination exists for more and more things in China. As millions of households enter the middle class, China's thriving consumer market has forged a hyper-competitive environment for attracting the spending of newly acquired disposable income.[54] Consumer goods and services—from tube socks, to basic groceries, to motor scooters—are bought and sold at cutthroat prices, often referred to as the "China price."[55]

Like with foreign investment, discussed below, prices are still deemed a matter of national security in China, granting the central government significant decision-making power. The inflation-led social instability created by the 1989 crisis still looms large in the minds of top officials. As a result, policymakers at the top and at China's central bank watch prices closely. In fact, China's consumer price index measure deviates from international statistical standards to more heavily weight consumer staples such as pork, cooking oil, rice, and garlic, among other items, thought to have the potential to elicit protest over rising costs of living.[56] Pressure to ensure stable garlic prices, for one, have led to extensive state involvement in garlic production and distribution since 1994, including the dumping of surplus garlic on international markets. [57]

Pricing reform is reaching previously untouchable parts of China's economy. In 2014, regulators unleashed mobile telecommunications operators by granting operators full autonomy over fees and

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[52] Barry Eichengreen, "A Tale of Two Tapers," Project Syndicate, July 11, 2013, available at https://www.project-syndicate.org/commentary/monetary-policyoverkill-in-the-us-and-china-by-barry-eichengreen.

[53] United States International Trade Commission, "China: Description of Selected Government Practices and Policies Affecting Decision-Making in the Economy" (2007) 43. available at http://www.usitc.gov/publications/332/pub3978.pdf

[54] Tom Doctoroff, *Billions: Selling to the New Chinese Consumer* (New York: Palgrave Macmillan, 2005).

[55] Alexandra Harney, *The China Price: The True Cost of Chinese Competitive Advantage* (New York: The Penguin Press, 2008).

[56] http://english.cri.cn/7146/2010/07/28/2001s585444.htm; http://www.chinaeconomicreview.com/reverse-engineering-chinas-dependably-stable-consumer-price-index

[57] Bill Lambrecht, "Illegal Chinese Garlic Imports Pounding U.S. Industry", *SF Gate,* Monday April 14, 2014, available at http://www.sfgate.com/news/article/Illegal-Chinese-garlic-imports-pounding-U-S-5396865.php. World Trade Organization, "United States- Countervailing Duty Measures on Certain Products from China" (2014) available at http://www.wto.org/english/tratop_e/dispu_e/437abr_e.pdf.

pricing models at the retail level.[58] Further reforms will allow third party companies—including foreign companies—to license and sell phone, text, and data services. More change is coming in the areas of healthcare and private education, and other typically non-tradable service industries, too.[59] Yet in other areas, market price mechanisms appear not to be functioning in guiding allocation decisions. For example, industries exhibiting global overcapacity continue to expand investment and output despite price and demand slumps. For example, China's shipbuilding industry, amidst a global oversupply in ships and declines in demand for shipping that saw new orders down 48 percent, actually increased shipbuilding by 7 percent in 2015.[60]

China's top economic administrative body, the National Development and Reform Commission, or NDRC, in its price department, administers pricing for energy utilities to ensure profitability for producers and at times to discriminate between certain industries or firms.[61] Utilities in China do not yet set prices based on supply and demand conditions. Instead, authorities are experimenting with a three-year pilot program aimed at market pricing of electricity transmission for commercial and residential users in the southern city of Shenzhen this year.[62] So far, the utility rates remain set by economic planning authorities at NDRC, although these policymakers are taking steps to reduce costs to household end-users. Reportedly, the murky pricing mechanism of the utility provider in the Shenzhen region, Southern Grid, derailed the company's bid for a Hong Kong IPO in 2008.[63] NDRC also still sets prices nationally for rail freight in China; only one freight rail line—running 180km between Inner Mongolia and Shanxi provinces—operates on conditions approaching supply and demand.[64]

Recent cases in multinational trade law reveal specific areas where a nexus of public policies in China effectively skewed price and output decisions. The 2014 rare earth elements, tungsten, and molybdenum case—critical components in advanced battery technologies and other uses in information and computing technology hardware—illustrates the multiple policy levers that can be pulled for the national economic goal of managing key resources. The case was brought by the United States in 2012, but joined subsequently by 18 third parties, including the European Union, Japan, Canada, South Korea, Brazil, Russia, India, and Trans-Pacific Partnership partner countries Japan, Viet Nam, and Peru.[65] In August 2014, a WTO appellate body confirmed findings the China imposed export duties, export quotas, and restrictions on which companies could produce and trade in these raw materials to impact their supply and price.[66] Chinese officials argue that the policies in question intended to manage conservation of an exhaustible natural resource, as may be

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[58] Lan Xinzhen, "Full-Pricing Autonomy", *Beijing Review,* May 29, 2014, available at http://www.bjreview.com.cn/quotes/txt/2014-05/27/content_620940.htm.
[59] Ibid.
[60] Yang, Ziman, "Sainty Marine first listed company to file for bankruptcy," *China Daily*, February 20, 2016, http://www.chinadaily.com.cn/business/2016-02/20/content_23566785.htm.
[61] Rosen and Houser, China Energy: A Guide for the Perplexed, (Washington: Center for Strategic and International Studies and the Peterson Institute for International Economics, 2007) at 18-22.
[62] Li Xuena and Huang Kaixi, "Shenzhen's Circuit Breaker for Power Pricing," *Caixin*, January 29, 2015, available at http://english.caixin.com/2015-01-29/100779668.html.
[63] Ibid.
[64] Lu Bingyang, "Economic Planner Raises Benchmark Rate for Cargo," *Caixin,* February 2, 2015, available at http://english.caixin.com/2015-02-02/100780804.html
[65] World Trade Organization, China—Measures Related to the Exportation of Rare Earths, Tungsten and Molybdenum, available at http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds431_e.htm last accessed November 17, 2015
[66] Ibid.

permissible under WTO's Article XX. However the appellate body noted "China had not satisfactorily explained why its trading rights restrictions were justified under this provision," and that the policies were not "necessary to protect human, animal, or plant life or health."[67]

Canada's trade enforcement actions involving China is instructive in considering NME status on an industry-by-industry case. The Canada Border Services Agency, or CBSA, handles customs services and sets a higher standard of proof that favors NME economies. In theory, this flexibility allows Canada to recognize the evolving and hybrid nature of China's economy, but in practice violations of trade rules remain difficult and costly to prove, particularly with the range of available indirect industry support. The CBSA found significant divergence between Chinese domestic prices and global market prices for subject goods in multiple markets.[68] Evidence that Chinese producers still choose to sell in markets where prices are lower than the domestic market support a conclusion that Chinese prices are not what they would be in a competitive market.[69]

CBSA also found that prices for raw materials in China deviated significantly from world prices, thereby transmitting price distortions through the production value chain into other goods. In a dumping case over aluminum extrusions, CBSA found significant deviation from the world price for aluminum on the London Metal Exchange in the Chinese price of aluminum on the Shanghai Futures Exchange.[70] CBSA found a similar pattern of non-market pricing for carbon steel welded pipe exported from China.[71] In a case over seamless casings, CBSA determined that Chinese producers used steel inputs (e.g. iron ore, coke) purchased at world prices, but that the resulting goods produced with these inputs still sold at below world market prices. Interventions can also deliver a benefit by dampening the volatility of prices relative to world market prices, as CBSA found in the oil country tubular goods steel dumping case, indicating that China exercised considerable control over prices.[72]

Specific findings from trade enforcement case evidence are reinforced with analysis of select prices for key goods in China relative to world market prices, showing there is still a wide disconnect. Some commodity prices follow quite closely to the short-term movements in representative world market prices, while others diverge from world market price trends or seem to move on their own volition. This suggests China's ability to "set" pricing for key inputs to production is not impervious to world market forces, but disruption to market price mechanisms can mean domestic prices move unpredictably from the global price trends.

Rigorous statistical tests using cointegration analysis can measure the responsiveness of prices in

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[67] Ibid.
[68] Canada Border Services Agency, *Seamless Casings: Final Determinations – Statement of Reasons*, February 22, 2008, available at http://www.cbsa-asfc.gc.ca/sima-lmsi/i-e/ad1371/ad1371-i-fd-eng.pdf
[69] Ibid.
[70] Canada Border Services Agency, *Aluminum Extrusions: Preliminary Determinations*, December 12, 2008, available at http://www.cbsa-asfc.gc.ca/sima-lmsi/i-e/ad1379/ad1379-i08-pd-eng.html; *Aluminum Extrusions: Final Determinations – Statement of Reasons*, August 7, 2009, available at http://www.cbsa-asfc.gc.ca/sima-lmsi/i-e/ad1379/ad1379-i08-fd-eng.html.
[71] Canada Border Services Agency, *Carbon Steel Welded Pipe 2: Preliminary Determinations – Statement of Reasons*, August 28, 2012, available at http://www.cbsa-asfc.gc.ca/sima-lmsi/i-e/ad1396/ad1396-i12-pd-eng.html.
[72] Canada Border Services Agency, Oil Country Tubular Goods: Preliminary Determinations – Statement of Reasons, May 8, 2010, available at http://www.cbsa-asfc.gc.ca/sima-lmsi/i-e/ad1385/ad1385-i09-pd-eng.html.

China's economy to world market prices.[73] Cointegration is a statistical property where a price series or other variable exhibits a stable long-run equilibrium relationship with another variable, tending to move together in proportion. Cointegration of prices in different economies would suggest that price changes in one economy impact upon and adjust to price changes in other economies. Such analysis can also suggest the direction of causality between one economy's price movements and prices on the world market. Testing whether prices for commodities in China are cointegrated with commodity prices around the world gives an indicator of the extent of the market-basis for price setting in China.

Analysis of a selection of representative prices shows that goods prices in China divide into 3 categories:

1. Prices integrated with and leading world prices – this means that economic activity in China drives changes in world market prices.
2. Prices integrated with and following world prices – this means that China's prices adjust, or are constrained to world market trends.
3. Prices with no long-term co-movement with world prices – this shows a fundamental disconnect from market-based prices.

In the first group we find: hot rolled steel and steel wire, coal, and iron ore. For these goods, prices in China's economy move in a long-term relationship to world prices. However, this does not necessarily entail that price-setting for these goods is happening under conditions of competitive supply and demand. Identifying the observed statistical interrelationships between a set of prices allows for estimation of how a shock, or unexpected one-time change, in one price reverberates through prices in related markets.

Take coal as an example: Figures 4A-4C show that a shock to world market coal prices, measured in prices for Australian, South African, and Colombian coal, has asymmetric effects on Chinese coal prices relative to world market prices. Figure 4A shows that, as a result of a price change in Australian coal translates into a change in Chinese coal prices only by about half of the size that a change in Australian prices has on Colombian and South African coal prices. A similar asymmetric effect can be seen in the response of Chinese and other world prices to a shock in South African coal prices.

What's more, the shock from changes in world coal prices is more permanent than changes in Chinese coal prices, which not only show a smaller influence of world prices, but also show that the effect of world price shocks does not last as long in affecting Chinese prices. China's asymmetric muted response to price changes on world markets reflects how market mechanisms are disrupted in China for this key input to electricity and other industrial applications. This analysis indicates that China is not impervious to market price forces. Chinese policies are still capable of managing prices to the favor of domestic industries—those that directly use coal in

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[73] Results of formal statistical tests of cointegration following the Johansen procedure under a range of assumptions indicate these three groupings. Insufficient number of observations to establish cointegration trend in iron ore prices. Data and Stata program available from the author. On cointegration of market prices, see Sorem Johansen, *Likelihood-Based Inference in Cointegrated Vector Autoregressive Models* (New York: Oxford University Press, 1995). http://scholar.harvard.edu/files/stock/files/cointegration_long-run_comovements_and_long-horizon_forecasting.pdf.

production in industries like steel and cement, and in general lower through lower electricity prices. Beyond the economic costs from market price adjustment, there are grave negative environmental externalities with real economic costs from excessive coal consumption and the range of pollutants to the local air quality and global carbon emissions.

Another example can be seen in prices for iron ore, another key input for raw steel. Figures 5A-B show that when iron ore prices spike on world markets, China's iron ore prices feel a mild short-term impact, and within 3 months not only does that shock disappear, but Chinese prices ratchet down on a persistent basis over the 24 months following a shock of increased world iron ore prices. In contrast, a rise in iron ore prices originating in China's domestic economy causes a short-term spike in world iron ore prices that is greater than four times the magnitude. World prices gradually adjust down as other producers expand their supply to satisfy increased demand from China for iron ore.

This kind of analysis also suggests that prices for some goods in China are integrated with and follow closely world market prices, meaning that prices in China adjust to or are constrained by world market trends. Copper prices are a particularly illustrative case where cointegration analysis finds China's domestic prices responding to world market conditions. Although China is a world-leading producer of mined copper, it does not produce enough to satisfy the demand for the use of copper for goods and investment in China and in production of consumer and investment goods for world markets. As a result, China is a large net importer of commodity copper products and a large producer and exporter of manufactured copper goods ubiquitous in all kinds of electronic and information and computing technology products and construction products. These items embody processed copper, and the rate at which China's economy processes copper is driven by the demands of consumers and investment in global markets, since the pace of copper demand for domestic use in China is trend-stable with China's high level of investment and average consumption growth.

2d. Regulation of joint ventures or other foreign investments

While inflows of foreign direct investment capital have helped China's economy flourish, investors enter an economy under well-known non-market conditions and at a distinct bargaining disadvantage relative to the leverage held by the Chinese state. Foreign businesses, urged on by the demands of short-term views in financial markets, are still desperate to get a piece of China's economy. The opportunities of to take advantage of rock-bottom manufacturing labor costs, increasingly sophisticated infrastructure, a growing pool of well-skilled workers and aspiring middle class consumers in China's burgeoning economy are lucrative.[74] That access often comes at a cost, a "choice" to invest in a joint venture with a domestic firm where foreign product and process technologies are readily learnable by domestic partners.

Global business face obligations to access both China's increasingly sophisticated production infrastructure and workforces as well as a piece of the largest and fastest growing world market.

[74] Donna Cooper, Adam Hersh, and Ann O'Leary, "The Competition that Really Matters" (Washington, Center for American Progress: 2012), available at: https://www.americanprogress.org/issues/economy/report/2012/08/21/11983/the-competition-that-really-matters/.

Policymakers in China use this advantage to leverage technology transfers from foreign investors. By restricting investment in China and market access, Chinese officials set take-it-or-leave-it terms for private-sector and foreign investment in the Chinese economy.[75] While a number of areas are strictly off limits to foreign investment—areas deemed critical to national economic security, a more expansive scope than most market economies take on what is critical for security—investment is actually encouraged in other areas, but under restrictions requiring minority joint ventures with a domestic firm as a means to facilitate technology transfer.

The strategy of regulating foreign investment for technology transfers can be seen in practice in the rapid development of China's high-speed rail technology. In 2004 the Ministry of Railway (MOR) solicited bids to make some 200 high-speed trains. The Japanese firm, Kawasaki Heavy Industries and its local partner, CSR Sifang Locomotive, won the largest portion of the 140 billion yuan contract. CSR Sifang's employees were trained by Kawasaki. However, Sifang later broke its contract with Kawasaki. Even though the trains emerging from Sifang's factories are identical to Kawasaki's models, the firm claims that the trains are based on their original designs.[76]

Since 1995, a positive list detailing the areas in which investment is encouraged, restricted, or prohibited for non-state and foreign investors governed China's investment restriction regime, the so-called "Catalogue for the Guidance of Foreign Investment, most recently amended in April 2015.[77] Pilot reforms in the Shanghai and other free trade zones in Tianjin and Guangdong province created since 2013 to move toward regulating foreign investment via a negative list—indicating which areas are prohibited or restricted for investment, rather than which limited areas were open—so far have merely replicated a mirror image of the existing positive list, meaning no practical change in how China's investment policies regulate joint ventures and other foreign investment. [78]

Subsequent revisions to the list in 2014 and 2015 served to decrease the count of listed items, but did so largely by merging of prior categorizations. In July 2014, the list shrank on a nominal basis to 139 items, down from 190. "Of the items that were eliminated, 14 correspond to areas where foreign investment was prohibited or permitted under certain conditions, 14 are prohibited to both foreign and Chinese investments, while the other 23 were consolidated with similar items."[79] In

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[75]The ability to set terms of investment is constrained in repeated interactions by the need to satisfy the investor's participation constraint. In other words, investors must still agree to the terms, which provides a check on policymakers bargaining position. Nonetheless, the ability to move first to set the terms provides a bargaining advantage. See, for example, Yasheng Huang, Capitalism with Chinese Characteristics: Entrepreneurship and the State (Cambridge: Cambridge University Press, 2008).

[76] Andrew Szamosszegi and Cole Kyle, "An Analysis of State-owned Enterprises and State Capitalism in China," (Washington: US-China Economic and Security Review Commission, 2011) 70-71.

[77] "Catalogue for the Guidance of Foreign Investment Industries (Amended in 2015)," available at: http://www.fdi.gov.cn/1800000121_39_4830_0_7.html (last accessed November 2015)

[78] Notice of the State Council on Issuing the Overall Plan for China (Tianjin) Pilot Free Trade Zone (Guo Fa 2015-19) http://www.gov.cn/zhengce/content/2015-04/20/content_9625.htm; Notice of the State Council on Issuing the Overall Plan for China (Guangdong) Pilot Free Trade Zone (Guo Fa 2015-18) http://www.gov.cn/zhengce/content/2015-04/20/content_9623.htm; Notice of the State Council on Issuing the Overall Plan for China (Fujian) Pilot Free Trade Zone (Guo Fa 2015-20) http://www.gov.cn/zhengce/content/2015-04/20/content_9633.htm. Timothy P. Stratford and others, "Navigating the FTZ – Special Coverage" (Shanghai, China: American Chamber of Commerce in Shanghai, 2013), available at https:// www.amcham-shanghai.org/NR/rdonlyres/89B7633D- 3682-4EBF-AC3F-F64D40151D1A/20363/1Cover1.pdf.

[79] The American Chamber of Commerce in Shanghai, "AmCham Shanghai Welcomes New FTZ Rules," 2014, available at http://www.amcham-shanghai.org/AmChamPortal/MCMS/Presentation/Template/Content.aspx?Type=32&Guid=%7B8F98C462-420B-4EB7-8B4E-0A4AEC600B36%7D.

2015, the list shrank again to 50 categories under which the previous listed items were re-grouped.[80] The newer lists also give more specific restrictions, making more transparent which areas of investment still need to meet particular conditionality, and also incorporates restrictions on foreign direct investment enumerated elsewhere in Chinese law.[81] In the most recent announcement, authorities called to gradually expand this negative list approach to the entire country by 2018.[82]

China's openness to foreign investment is changing in other ways, but this change is limited to industries in which China's policymakers do not place strategic economic importance like low value-added and unskilled labor-intensive manufacturing and in industries that are not trade-competing or where knowledge and technology are not readily appropriable like in education and health care services.

The past decade has seen creation of a new vehicle for foreign investment in China—the wholly foreign owned enterprise, or WFOE that proliferated within the industries where such activities are permissible. [83] However, the opportunity to establish WFOEs is still governed by the positive list investment catalogue—meaning only in explicitly permitted industries, and places a host of other regulatory hurdles on such investment. The Ministry of Commerce still exercises discretion to accept or reject registration applications for WFOEs. Other policies are designed to limit competition, providing favored firms with monopolistic power. For example, foreign-owned construction firms may establish a local presence in China, but regulations limit operations to construction projects that are wholly funded by foreign investors.[84]

Currently, foreign investors are pushing the boundaries of China's formal investment regime by forming so-called variable interest entities, or VIEs, which garnered attention in Alibaba Group's 2015 IPO on the New York Stock Exchange.[85] VIEs exist under the radar, but with a passive nod from China's foreign investment regulators practicing a kind of "don't ask, don't tell" policy. Proposed reforms would provide more formal security for property rights of VIEs, in essence, protecting the legal claim to earned profits, while preserving control of the firm in the hands of Chinese legal persons by allowing majority Chinese firms to register as "Chinese-invested," affording full legal rights and ability to contest those rights in Chinese courts, such as it is. [86] VIEs are typically financial holding companies incorporated in low-tax, low-transparency jurisdictions such as the British Virgin Islands or Cayman Islands where shareholders in the VIE own a

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[80] Chinese State Council, "State Council on the issuance of free trade test area inform the foreign investment access special management measures (negative list) of," April 20, 2015, available at http://www.gov.cn/zhengce/content/2015-04/20/content_9627.htm.

[81] *China Briefing*, "The New Free Trade Zones Explained, Part II: The Negative List," April 30, 2015, available at http://www.china-briefing.com/news/2015/04/30/new-free-trade-zones-explained-part-ii-negative-list.html.

[82] *Xinhua*, "China sets timetable for nationwide "negative list" approach," October 19, 2015, available at http://news.xinhuanet.com/english/2015-10/19/c_134729043.htm.

[83] Linda Yueh, *Enterprising China: Business, Economic, and Legal Developments since 1979* (Oxford: Oxford University Press, 2011) https://global.oup.com/academic/product/enterprising-china-9780199205837?cc=us&lang=en&.

[84] United States International Trade Commission, "China: Description of Selected Government Practices and Policies and Policies Affecting Decision-Making in the Economy" (2007) 101. (Available at: http://www.usitc.gov/publications/332/pub3978.pdf)

[85] Ibid.; Jack Ma, "Alibaba's IPO Puts VIE Structure in the Spotlight," *The Wall Street Journal*, September 22, 2014, available at: http://blogs.wsj.com/riskandcompliance/2014/09/22/alibabas-ipo-puts-vie-structure-in-the-spotlight/.

[86] Charles Clover, "China proposes to change status of foreign stakes in tech sector," *Financial Times*, January 22, 2015, available at: http://www.ft.com/intl/cms/s/0/dc6b479a-a211-11e4-aba2-00144feab7de.html

contractually-specified share of revenues earned by the actual underlying company—a way to own part of the profits without owning control of the company. Except that in China, investors have no real legal claim to these profits. [87]

The future of VIEs as a means to end-run China's restrictions on foreign direct investment remains uncertain. Certainly there are successful examples—from the foreign investor's perspective—but there are also many examples where the domestic enterprise is high jacked by managers or defrauds investors, who have no legal recourse. It is possible that policy reforms may catch up to practice, validating these foreign property rights, but this is by no means a foregone conclusion and foreign investors should be aware they are undertaking more than just normal country risk in flagrantly evading China's foreign investment regime.

It is reasonable to expect that no significant changes to foreign investment regulation will occur prior to conclusion of the bilateral investment treaty currently under negotiation with the United States—lest Chinese negotiators unilaterally cede bargaining leverage in this negotiation.

2e. Labor rights and wage bargaining

Where China most shortfall of the market economy criteria is most clear-cut is in the standard for labor rights and wage bargaining. Like in other areas of China's economy, China's labor markets have transformed radically over the past 35 years. The trend of an increasing share of private sector employment (as shown in Figure 2) will continue as more of China's rural population moves to the city in search of better opportunities where they can be more productive, and as previously underdeveloped service sector industries expand. Better opportunities means, bluntly, people getting out of subsistence agriculture, and getting plugged into China's "modern" manufacturing and service sectors. But it also means China's economy must create better quality jobs—ones that respect fundamental rights and afford a decent standard of living.

As of 2013, there were over 793 million people in China's labor force, and fueling economic growth for such an enormous population is not a simple task.[88] Although wage-setting in China's labor markets occurs on a competitive basis, that competition is dominated by employers, not the workers who have very limited power in work relationships. All of these workers in China enter the wage bargain in a labor market operating under what Cornell University political scientist Eli Friedman describes as a system of "appropriated representation" built on the premise that begins with one party, in control of the state, unilaterally claiming exclusive representation over all the people.[89] In other words, the state is the "voice" of all workers.

In this labor market, widespread abuses and abhorrent conditions fill volumes of official government and NGO reports and regularly feature in the press.[90] Countless more go unreported or observed. In international law, China has yet to ratify the four labor rights conventions that the International Labor Organization defines as fundamental and that U.S. and other countries law recognize as a foundation of a market economy. The conventions China has not yet ratified provide

[87] Ibid.
[88] *China National Statistical Yearbook. http://www.stats.gov.cn/tjsj/ndsj/2014/indexeh.htm*
[89] Eli Friedman, *Insurgency Trap* (Ithaca: Cornell University Press, 2014).
[90] Human Rights Watch, "World Report 2014: China" (2014).

for the freedom of association and right to collective bargaining, and for the abolition of forced labor.[91] China has ratified fundamental rights conventions establishing a minimum working age and prohibiting the worst forms of child labor, as well as those pertaining to non-discrimination in pay and in the workplace—both of which remain prevalent.[92] The prohibition of freedoms of association and collective bargaining are a key pillar of the authoritarian one-party political system in China, which delegates authority, on the frontlines, to express the People's "voice" to the All-China Federation of Trade Unions, or ACFTU, which counted some 280 million members in 2013, or 38 percent of China's overall labor force at the time.[93]

The ACFTU is not like worker organizations in other countries that do recognize the aforementioned basic human rights in ILO conventions. Workers in China do not have the right to form independent organizations in China outside of the ACFTU federation, nor do they have the right to select the federation's leadership through democratic means. Top leadership positions are ministerial level within China's governance structure, and the head of the ACFTU is an alternate member of the Communist Party's 30 member Central Committee—akin to the U.S. president's cabinet, if there were no separation of powers and checks and balances from the legislative and judiciary functions of government.

Nor do workers in China get to elect representatives at the factory level, where the process is controlled by firm managers—be it in a foreign-invested company, or an SOE—in conjunction with local political leaders. In both cases, the principle may in fact be the same "legal person" or at least a legal person under the formal or informal influence of local officials; workers have no say in choosing who will be their representative voice.

China's workers do have some rights on paper. These are set out primarily in the 1994 Labor Law, the 1992 Trade Union Law (amended 2001), the 2008 Labor Contract Law (amended 2013), the 2008 Labor Dispute Mediation and Arbitration Law and the 2008 Employment Promotion Law.[94] Individual employees have the right to an employment contract, a minimum wage, a 40-hour working week with fixed overtime rates, social insurance covering pensions, healthcare, unemployment, work injuries and maternity, severance pay in the event of contract termination, equal pay for equal work, and protection against workplace discrimination. Workers also have the right to form an enterprise trade union, and the enterprise union committee has to be consulted by management before any major changes to workers' pay and conditions are made. [95] Every province is mandated to set a minimum wage that is not less than the local average wage; foreign-invested enterprises are required to pay "not less than 120 percent of the average wage paid by SOEs in the same line of business in the locality." [96]

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[91] These refer to ILO Conventions 28, 87, 98, and 105.
http://www.ilo.org/dyn/normlex/en/f?p=1000:11210:0::NO:11210:P11210_COUNTRY_ID:103404.
[92] ILO Conventions 100, 111, 138, and 182,
http://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:11200:0::NO::P11200_COUNTRY_ID:103404.
[93] Global Times, "China's trade unions have 280 mln members," October 11, 2013, available at
http://www.globaltimes.cn/content/817211.shtml.
[94] Sources for specific labor laws can be found here: http://chinalaborwatch.org/labor_laws_and_compliance.aspx.
[95] Ibid.
[96] The Economist Intelligence Unit, "Risk Briefing, China Risk: Labor Market Risk," (2006). Zimmerman, James, "China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises," 2nd edition (Chicago:
American Bar Association, 2005), at 393.

These social protections do not cover workers in all sectors and occupations in the economy, but for the public sector, public enterprises, and foreign-invested enterprises. And, like other aspects of China's economy, enforcement of the rules of the labor market is at the local level, where officials and business interests are closely aligned. Even in China's expanding white collar and service economy labor markets, discrimination is prevalent. It is customary practice for job applicants to list their ethnic heritage (though others' surnames can be a giveaway), and for women to include photographs and sometimes specify their height and weight. However comprehensive these laws are on the books, they are not uniformly observed or enforced.

Instead of empowering employees, the ACFTU acts as enforcement for corporate and government interests. The 2001 Trade Union Law states that, "The trade union shall assist the enterprise or institution in properly dealing with the matter so as to help restore the normal order of production and other work as soon as possible."[97] Green shoots of civil society organizations—worker centers where workers can receive education on the laws and legal aid and their staff are routinely targeted for scrutiny and intimidation by a range of tactics. Workers seen interacting with workers centers can be targeted for dismissal, physical threats, and reportedly even threats delivered to family members in migrant workers' home communities that the person is "making trouble."[98] According to the *Financial Times*, in 2014 "Chinese authorities used public disorder charges to round up legal activists and constitutional reformers in a crackdown" on anti-corruption advocates, Nobel laureates, and worker-protestors organizing outside the official ACFTU for reasons of unsafe working conditions, denial of back wages, and fair compensation and benefits payments.[99]

In addition to the difficult conditions of work brought to light in high-profile cases like the suicides of Foxconn workers, wage theft and discrimination are common complaints among employees.[100] Not only do employers withhold overtime pay, but routinely falsify their share of contributions to retirement saving and health care saving plans, which employees may not find out about until long after the fact.

Such complaints gave rise to a wildcat strike in April 2014 at Yue Yuen, a Taiwan owned company, the world's largest OEM shoe manufacturer. More than 40,000 workers went on strike for two weeks because Yue Yuen had under-contributed the social security payments for employees.[101] The Yue Yuen was a rare case. The stand-off between so many striking workers and management drew international attention, and resulted with people returning to work with restitution and seemingly with little retribution. Wildcat strikes like this are on the rise, according to official figures as well as independent data compiled by Hong Kong based labor NGO group China Labour Bulletin counted 1,378 non-ACFTU sanctioned incidents in 2014.[102] Most meet with darker outcomes reminiscent of the militant union-busting tactics in the turn-of-the-20th-century United States.

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97 http://ilera2012.wharton.upenn.edu/NonRefereedPapers/Kuruvilla,%20Sarosh%20and%20Elfstrom,%20Manfred.pdf
98 Anonymous NGO workers and advocates, interview with author, Southern China.
99 Tom Mitchell, "China crackdown on labour activism bolstered by court ruling," *Financial Times*, April 15, 2014, available at http://www.ft.com/intl/cms/s/0/aa194620-c46d-11e3-8dd4-00144feabdc0.html?siteedition=intl.
100 China Labor Watch, "Mattel's Unceasing Abuse of Chinese Workers: An investigation of six Mattel supplier factories," October 15, 2013, available at http://www.chinalaborwatch.org/report/70.
101 Leah Borromeo, "How Adidas supported worker rights in China factory strike," *The Guardian*, June 12, 2014, available at http://www.theguardian.com/sustainable-business/sustainable-fashion-blog/adidas-worker-rights-china-factory-strike.
102 China Labour Bulletin, "Strike Map," available at http://maps.clb.org.hk/strikes/en.

In response to increasing strikes, Guangdong province Standing Committee in September 2014 independently issued new regulations "to regulate conduct of collective negotiations, to improve the system of collective contracts, to protect the legal rights of employees and enterprises, and to establish harmonious and stable labor relations."[103] Although this reform marked a step forward in defining a right to collective bargaining and obligations of the parties, it did nothing to change the existing local ACFTU structures that prevent free association and democratic representation. As if to punctuate the significance of the change, even before the law went into effect in January 2015, the labor research center at Sun Yat Sen University in Guangdong, where legal scholars helped write the new law, was shut down by officials.[104]

3. Concluding Concerns for U.S. Policymakers

I will conclude with three areas of concern for U.S. policymakers.

First, challenges remain in many areas for China's economy to meet the market economy criteria where competition on a slanted playing field poses real costs to businesses, employment, and wages in the United States (and China's other trading partners). Although China's leaders should have the autonomy to pursue their own choice of development strategy, U.S. policymakers can make clear the costs and benefits of particular choices and structure incentives to move the will of policymakers toward internationally accepted norms of commercial and financial competition. This means retaining and using all possible leverage in managing the economic relationship with China by recognizing and highlighting the nonmarket features of China's economy and the costs these impose on Chinese people as well as on others in the global trade and production systems.

Second, U.S. policymakers—members of Congress in particular—should look carefully at what impact the proposed Trans-Pacific Partnership agreement will have in strengthening the economic position of China's nonmarket institutions. Although proponents of the Trans-Pacific Partnership offer this trade and investment agreement, the agreement's incredibly weak "Rules of Origin" actually create a backdoor for content from outside the region—from China and other countries—to gain entry to TPP markets without being held to the standards of the agreement or offering reciprocal market opening.

These rules of origin specify how much content must be produced within TPP countries to qualify for tariff-free market access. High standards would ensure the benefits of trade flow to partners offering reciprocal market opening. NAFTA required more than 60 percent regional content for the North American automotive market. TPP, in contrast, sets the origin threshold so low that even if the vast majority of value-added content came from countries outside, it may be able to get preferential treatment under TPP. Most industrial and consumer goods will need just 30 percent content, while food and chemical products will need 35-40 percent.

Once combined with sufficient other qualifying inputs—other parts or even minor manufacturing processes, outside content can be counted as 100 percent of TPP origin. For example, raw steel

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[103] Standing Committee of the Guangdong Provincial People's Congress, The Standing Committee of the Twelfth People's Congress of Guangdong Province Public Notice1 (No.21), Unofficial English Translation, September 25, 2014, available at http://laborcenter.berkeley.edu/pdf/2014/guangdong-regulation-collective-contracts.pdf.

[104] Chun Han Wong, "China Labor Ties Fray as Grievances Rise, Economic Growth Slows," *The Wall Street Journal*, February 9, 2015, available at http://www.wsj.com/articles/china-labor-ties-fray-as-grievances-rise-economic-growth-slows-1423528666.

tubing from China—where state-owned producers are currently glutting global markets, fueling China's epic smog crisis and accelerating global climate change—can be imported to a TPP country, threaded or heat-treated, and magically transform to a "Made in TPP" steel. Imagine such a part is combined with another 70 percent of non-TPP content to make a new good. Quickly, more than 90 percent of the value can come from outside TPP and still qualify for benefits under the agreement. This is the worst of both worlds: goods sourced from countries that do not commit to TPP's labor, environment, and other standards or reciprocate market opening to our goods can still get free access to TPP markets.

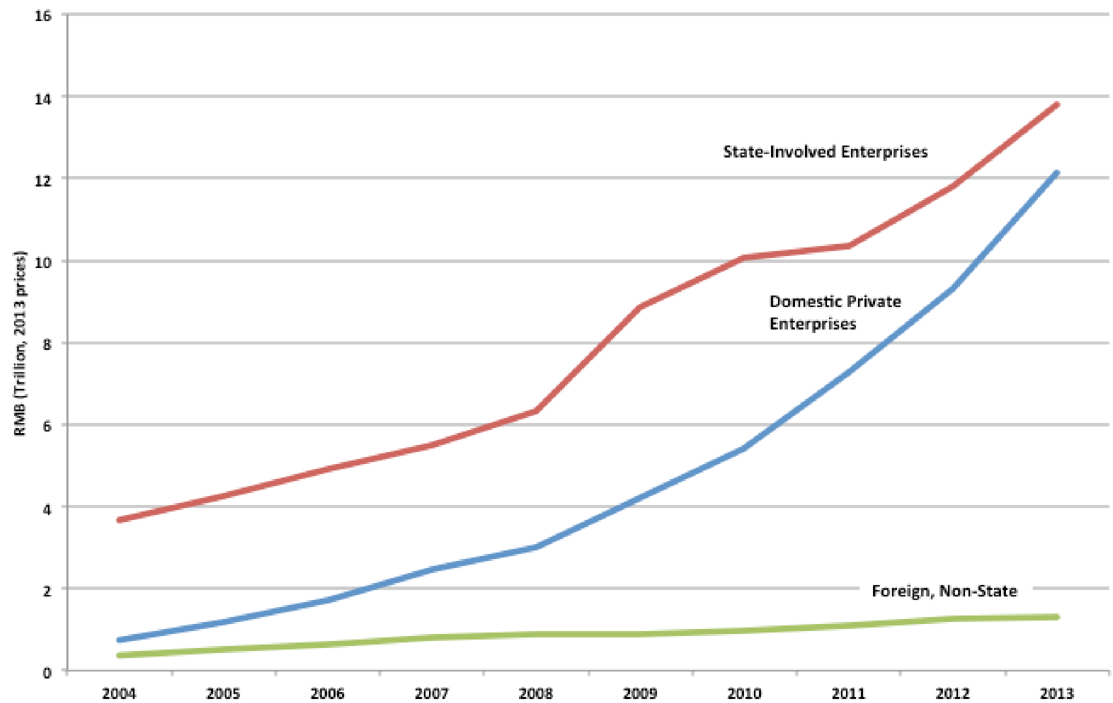
TPP partners Australia, New Zealand, Singapore, and Malaysia have already promoted China to market economy status under WTO rules, meaning that four key partners will be admitting Chinese content without considering the potentially unfair origins of such goods.

Third, ongoing negotiations between the United States and China for a bilateral investment treaty, or BIT, presents serious economic risks for the United States by giving Chinese enterprises access to the extremely unfair and anti-democratic investor-state dispute settlement mechanism that exists in TPP and similar earlier U.S. trade and investment agreements. Certainly China's treatment of foreign investors shows much room for improvement, but if the U.S.-China BIT follows the model favored by USTR negotiators foreign investors will be granted a new set of property rights allowing them to sue governments in private international tribunals over pretty much any law, regulation, or government decision for compensation when these rights are violated, even if government actions are nondiscriminatory. In essence, any change in policy or regulation after the agreement takes effect can be subject to such disputes.

From the U.S. perspective, this will mean that multinational companies will gain even stronger tools and incentives for moving investment and jobs offshore to low-standard countries. The BIT will allow U.S.-based multinationals to dispute future policies in China aimed at cleaning up environmental pollution, improving working conditions and raising wages, or ensuring consumer safety and public health. This is not hypothetical risk, but the track record of such investor dispute systems already in force. In a case using NAFTA's similar investment provisions, arbitrators ordered Canada to pay American waste disposable company S.D. Myers $5.6 million because it prohibited the export of toxic industrial waste—exports that were banned by international treaty and applied to Canadian and foreign firms alike. The company's lawyer boasted, "It wouldn't matter if a substance was liquid plutonium destined for a child's breakfast cereal. If the government bans a product and a U.S.-based company loses profits, the company can claim damages."

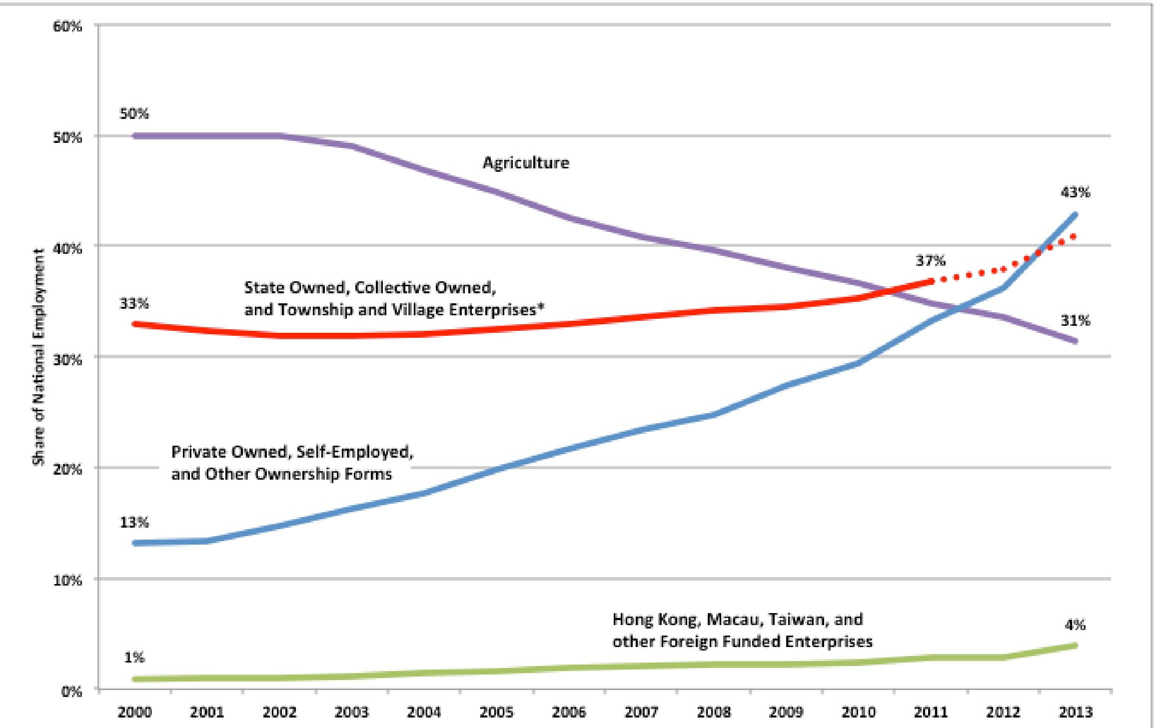
Policymakers should also be aware that this dispute settlement mechanism is also a two-way street, meaning Chinese enterprises that are expanding their overseas investment footprint in the United States will gain a much more favorable mechanism institution to challenge policies of the federal, state, and local governments in the U.S. As China's economy has developed, so too has its willingness and ability to bring trade disputes under the WTO. U.S. policymakers should assume that this will be true of a potential BIT as well, and contemplate the full range implications from including such flawed investor protections and adjudication mechanisms in any international agreement, let alone with China.

Figure 1: Investment in State-involved, Domestic private, and Foreign non-state enterprises



Source: Author's analysis of CEIC China Database data.
Adjusted for inflation using fixed asset investment price index.

Figure 2: Employment by Business Ownership Form and in Agriculture



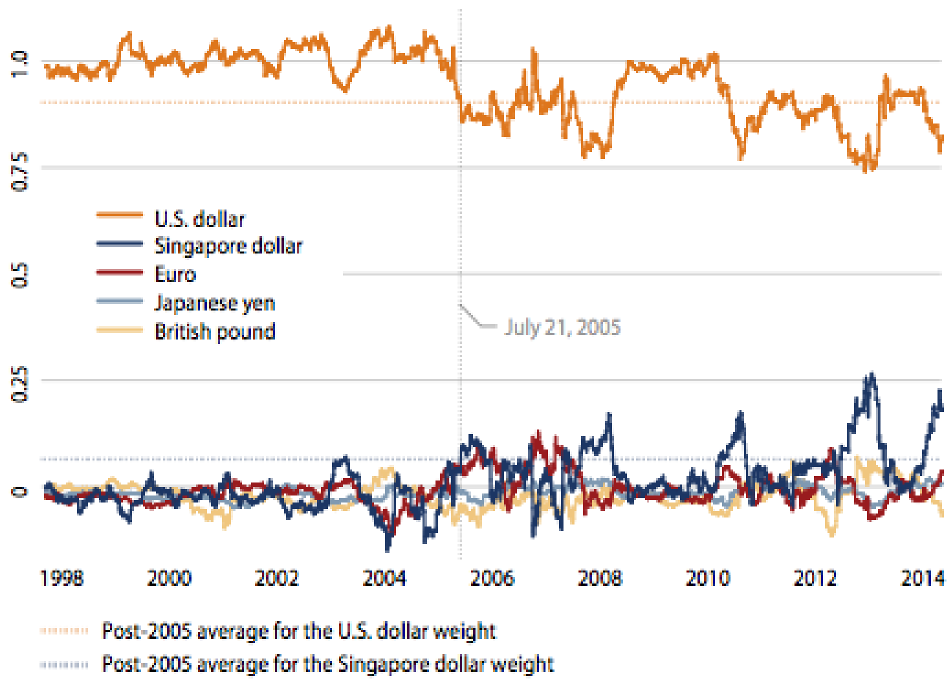
Source: Author's analysis of CEIC China Database data.
*Township and Village Enterprise data, the largest component, are not reported for 2012 and 2013--dashed line represents estimates.

Figure 3: Currencies in China's Exchange Rate Basket

FIGURE 3

Currencies in China's exchange rate basket

Percent weight in China's exchange rate basket



Source: Author's analysis of International Monetary Fund data. Estimated weights (coefficients) for 180-day rolling regressions based on model (4) in Jeffrey Frankel and Shang-jin Wei, "Estimation of De Facto Exchange Rate Regimes: Synthesis of the Techniques for Inferring Flexibility and Basket Weights," (NBER Working Paper No. 14016) available at http://www.nber.org/papers/w14016.

Figure 4: Effect of Price Shocks on World Coal Prices

Figure 4A: Effect of Change in Australian Coal Price

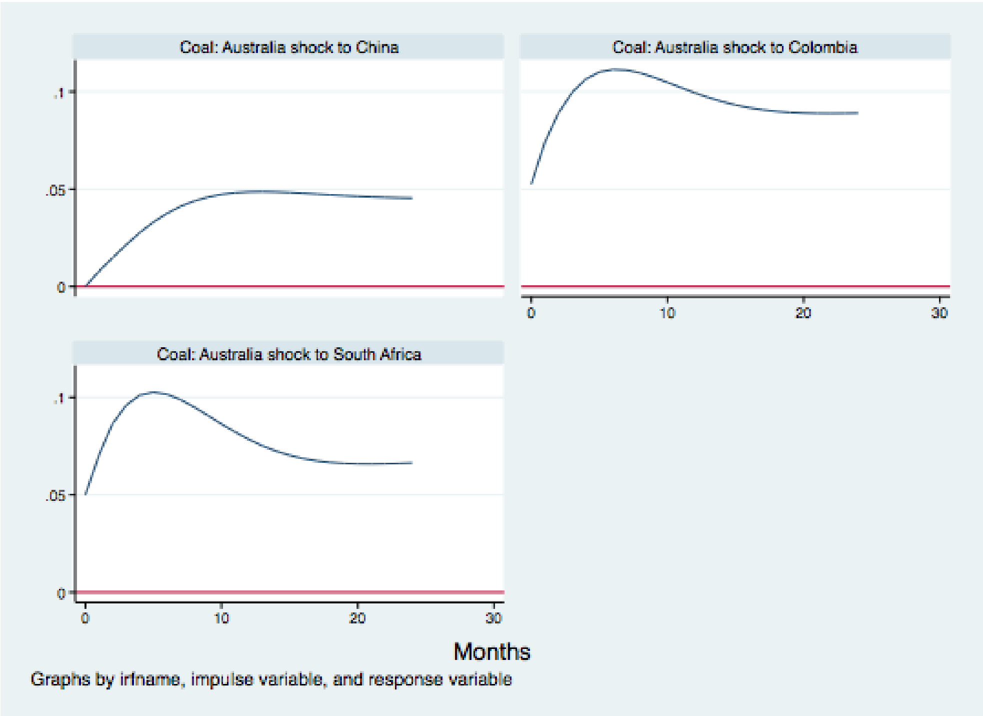


Figure 4B: Effect of Change in South African Coal Price

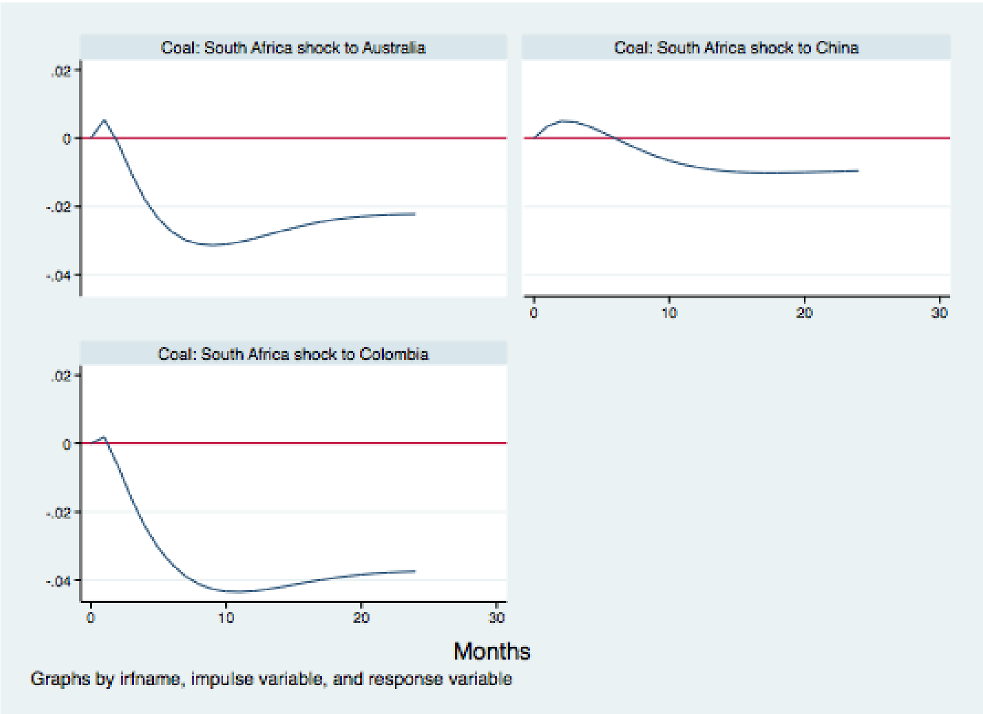


Figure 4C: Effect of Change in Chinese Coal Price

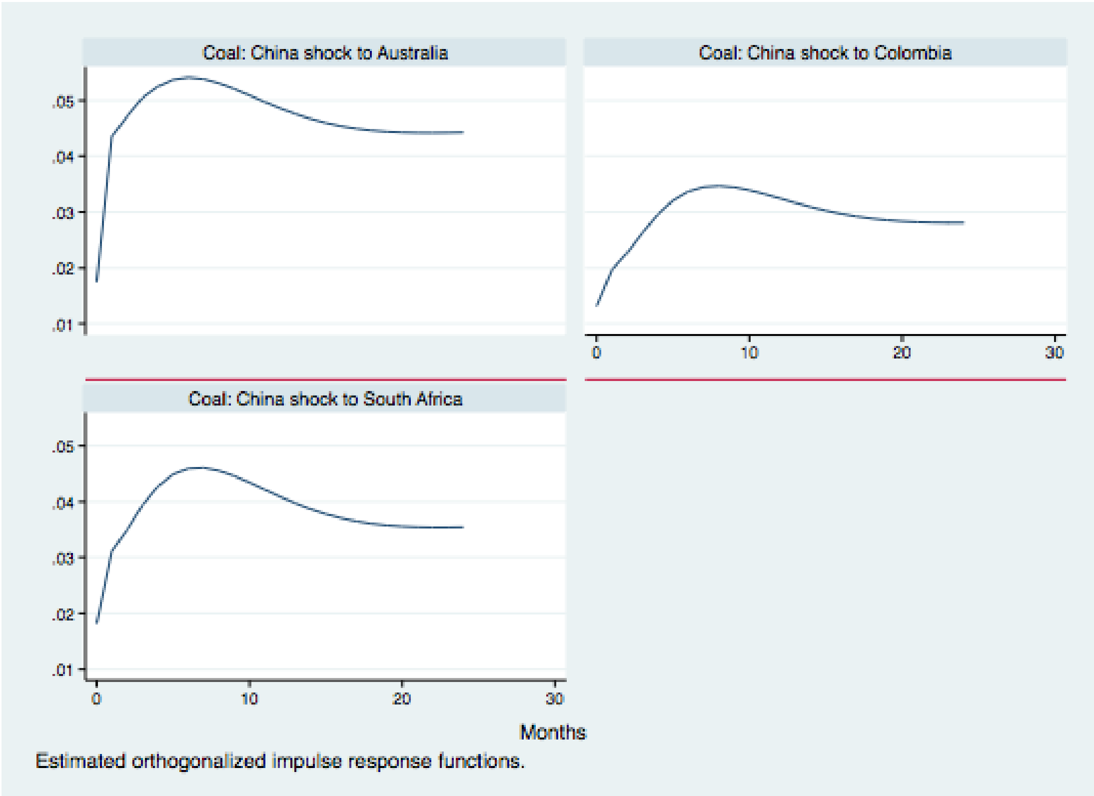


Figure 5A: Effect of World Iron Ore Price on China Price

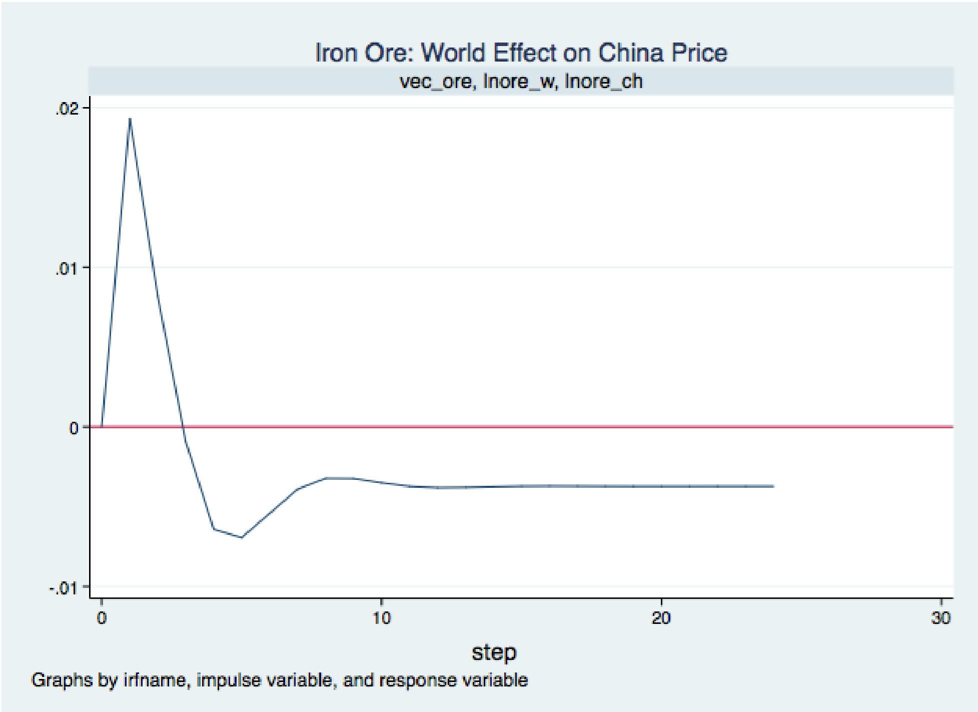
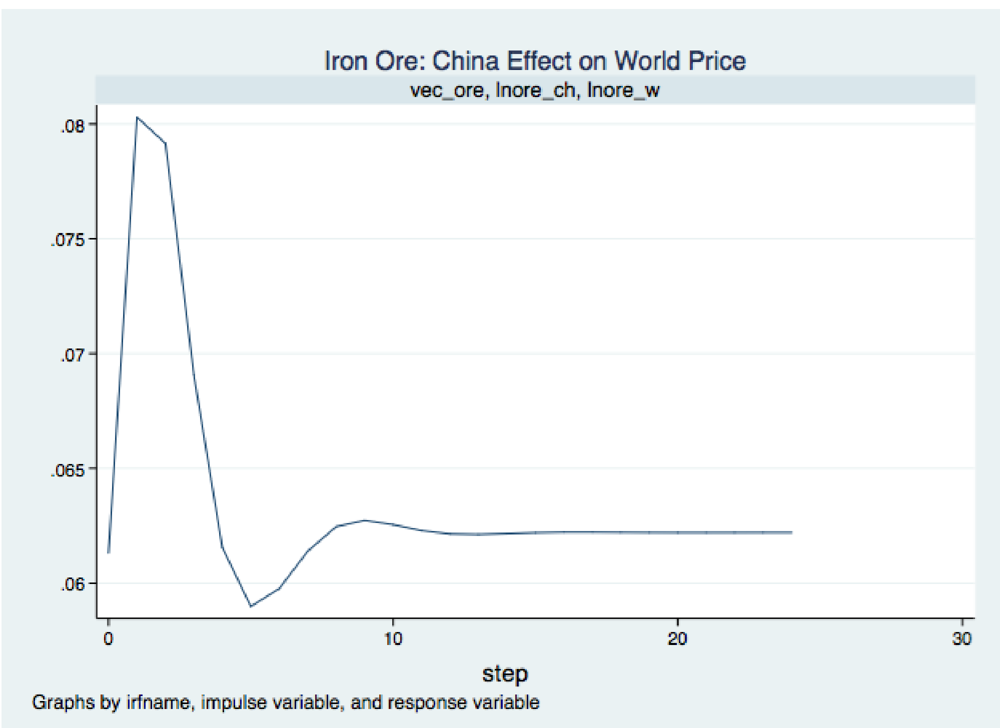


Figure 5B: Effect of China Iron Ore Price on World Price



OPENING STATEMENT OF DR. GARY CLYDE HUFBAUER
SENIOR FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

DR. HUFBAUER: Thank you.

Contrary to Mr. Price, there are distinguished economists who say that China is now predominantly a market economy, and I would cite my colleague Nicholas Lardy who wrote quite a good book titled Markets Over Mao. One of the points he makes is that the state denominated sector is now around 25 percent of the economy against virtually 90 percent at the beginning of the Deng era.

The further point I would make on the general characterization of China is that the extent of planning and state control in China is not greater than in France or Sweden, which control the health, transport, energy sectors, which are far greater than steel and aluminum, which we're talking about today. Then just beyond those advanced countries, look at India and Brazil. I mean the amount of state control in those countries is terrific, but we don't call them nonmarket economies.

And if Jeremy Corbyn should become the British Prime Minister, you can watch out because we'll be back to nationalization of a lot of industries in Britain. Are we going to call Britain a nonmarket economy?

So I think the general characterization of China today as a nonmarket economy is just not consistent with the facts. Now, it is true that U.S. law and EU law, as we will hear in a moment, leave it as a matter of domestic discretion whether to characterize China as a nonmarket economy, and the discretion in our country is entrusted to the Department of Commerce.

The WTO provisions, you've heard about them, and I discuss them in my testimony. It's dancing on the head of a pin. I won't do another pirouette for you. If this case goes to the WTO, it will certainly enrich practicing lawyers because there will be a lot of litigation. Consulting economists will get good business as well.

But my opinion, and it's no more than that, is that the WTO would finally side with China. However, if the U.S. says China is still a nonmarket economy in certain sectors, or consistently a nonmarket economy, then it won't be until 2018 before the WTO issues a decision. Remember that there is no retroactive relief in the WTO for wrongly applied antidumping or countervailing duties, so China will take a heavy hit.

My view, as stated in my short written testimony, is that the U.S. policy decision should not turn on intricate legal arguments which go to the phrasing of China's Protocol of Accession. They should instead turn on U.S. interests. I recognize that in December 2016 the currency issue might be a hot question. Right now, China is supporting its currency to the tune of several hundred billion dollars. Today you can't call China a currency manipulator in the sense we were talking about last year. Times may change. There may be other issues as well. I realize there are big geopolitical factors at work.

As I mentioned in the written testimony, the Department of Commerce could apply a "mix-and-match" approach saying some sectors--steel would be a principal one; aluminum perhaps another--are nonmarket economy, but the rest of the Chinese economy is a market economy. It could do that, and that may stand a better chance of surviving WTO review, though I don't think it would survive.

But from a U.S. policy standpoint, the U.S. should also consider the cost of opaque retaliation by China. There's ample evidence that China would retaliate in trade terms. Especially if the EU and Canada and other countries do recognize China as a market economy, the U.S. would be all alone. That would be a cost to us. I'm just talking economic costs. There would be political costs as well.

And the U.S., again, as a policy matter, should look at the possible difference between antidumping and countervailing duties assessed on a nonmarket economic basis as opposed to a market economy basis.

Now since we haven't been using market economy determinations of penalty duties for China, we don't have much factual evidence, but I think that with the strong abilities in the Commerce Department its experts could make some tentative calculation. My guess is that you might gain an extra 20 percent on top of otherwise very high CVD and ADD duties by characterizing China as a nonmarket economy in certain sectors. Steel again comes to mind.

Whether that 20 percent extra makes much difference in terms of imports on top of what I think will be very high CVD and AD margins is quite questionable, and there are the costs on the other side.

Thank you.

HEARING CO-CHAIR CLEVELAND: Thank you very much.

PREPARED STATEMENT OF DR. GARY CLYDE HUFBAUER SENIOR FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Statement on Market Economy Status for China

Gary Clyde Hufbauer
Peterson Institute for International Economics[1]

Testimony before the U.S.-China Economic and Security Review Commission
Hearing on "China's Shifting Economic Realities and Implications for the United States"
Panel 4 "Evaluating China's Non-Market Economy Status"
February 24, 2016

Article 15 of China's Protocol of Accession to the World Trade Organization (WTO), dated November 10, 2001, generally allowed other WTO members to disregard Chinese prices and costs in antidumping (AD) cases and instead base the calculation of dumping margins using external benchmarks.[2] An exception was made if Chinese producers could "clearly show" that market economy conditions prevailed in the industry. Article 15 essentially authorized "nonmarket economy" (NME) methodologies long used by the United States and the European Union in AD cases against imports from communist countries.

Taking advantage of this provision, authorities in the United States, European Union, Japan, and Canada, among others, almost always use surrogate prices and costs to calculate Chinese dumping margins. Rarely are the authorities satisfied that market economy conditions prevail in Chinese industries.

The comparison of Chinese export prices with surrogate prices and costs, rather than Chinese prices and costs, typically leads to much higher dumping margins. Since China is a leading target of dumping cases worldwide,[3] the NME methodology is a sore point with Chinese officials. In fact, more than 10 years ago, China mounted a vigorous diplomatic campaign asking trade partners to accord China market economy status (MES). The campaign succeeded with New Zealand (April 2004),[4] Singapore (May 2004),[5] Malaysia (May 2004),[6] Australia (April 2005),[7] and other countries, but not with the United States, the European Union, Japan, Canada, and several others.

Which brings us to the looming WTO issue. Article 15(a)(ii) of the Protocol states:

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[1] This statement is largely based on a blog post by Gary Hufbauer and Cathleen Cimino-Isaacs, "Looming US-China Trade Battles?: Market Economy Status (Part II)," Trade and Investment Policy Watch, March 9, 2015, http://blogs.piie.com/trade/?p=145.

[2] As external benchmarks, the United States values Chinese factors of production (labor of different qualities, energy, materials, etc.) at prices published by the World Bank or another reliable source for conditions in a market economy. The European Union instead uses the costs of a surrogate firm in another country that makes the same product. Using such external benchmarks for normal value in an AD case actually compensates automatically for any undervaluation of the Chinese currency, since the values are expressed (and come from) currencies of market economy countries.

[3] In 2014, 63 AD cases were filed against China, out of a total of roughly 240 initiated worldwide. See www.antidumpingpublishing.com/statistics/.

[4] "New Zealand Gives China Market Economy Status," *China Daily*, April 16, 2004, www.china.org.cn/english/BAT/93136.htm.

[5] "Singapore Recognizes China's Full Market Economic Status," *Xinhua News*, May 15, 2004, http://china.org.cn/english/MATERIAL/95470.htm.

[6] "Malaysia recognizes China's full market economy status," Embassy of People's Republic of China, May 29, 2004, http://in.chineseembassy.org/eng/jjmy/t122928.htm.

[7] "Australia grants full market economy status to China," *Asian Tribune*, April 20, 2005, www.asiantribune.com/news/2005/04/20/australia-grants-full-market-economy-status-china.

> The importing WTO Member may use a methodology that is not based on a strict comparison with domestic prices or costs in China if the producers under investigation cannot clearly show that market economy conditions prevail….

However, buried in Article 15(d) is the critical sentence:

> In any event, the provisions of subparagraph (a)(ii) shall expire 15 years after the date of accession.

Chinese officials insist that this sentence requires all countries to accord China market economy status on December 11, 2016, 15 years after China's accession, and that WTO members can no longer use surrogate costs and prices in AD cases.

Some lawyers read the text differently. While they agree that Article 15(a)(ii) effectively disappears on December 11, 2016, they do not agree that the Protocol confines WTO members to a binary choice between MES (strict comparison of export prices with Chinese prices or costs) and NME (comparison with surrogate prices or costs). They point to the opening language in Article 15(a), which states:

> …the importing WTO member shall use either Chinese prices or costs for the industry under investigation or a methodology that is not based on a strict comparison with domestic prices or costs in China….

To be sure, under Article 15(d), the whole of Article 15(a) disappears:

> Once China has established, under the national law of the importing WTO Member, that it is a market economy, the provisions of subparagraph (a) shall be terminated….

The United States might well argue, come December 11, 2016, that China has not established that it has become, in all important respects, a market economy. The Commerce Department could modify its current surrogate practices and instead use a "mix-and-match" approach—claiming on a case-by-case basis that some Chinese prices or costs reflect market conditions and others do not. For the prices or costs that do not reflect market conditions, the Commerce Department could use surrogate prices or costs. This seems most likely in industries, such as steel, dominated by state-owned enterprises, with large losses financed by state-controlled banks. Whether the United States takes a "mix-and-match" approach, rather than granting China blanket market economy status, will turn primarily on policy considerations, not legal parsing. The policy decision may reflect the general atmosphere of commercial relations with China late in 2016, including the evolution of the renminbi exchange rate (manipulated devaluation would inspire a harder line)[8] and the outcome of US-China bilateral investment treaty (BIT) negotiations (success would have the opposite effect).[9]

Assuming the United States adopts a "mix-and-match" approach, the stage will be set for China to initiate WTO litigation. In this scenario, the year 2018 seems the earliest date for a final decision by the WTO Appellate Body. My guess is that the Appellate Body would rule against the "mix-and-match" approach. Even so, China would not receive retroactive refunds for antidumping duties collected prior to the ruling. Moreover, within China, the US denial of full-fledged MES would resonate strongly, in a negative way. Antagonism would be particularly strong if, as I expect, the European Union and other major countries accord MES in December 2016. Consequently, China would likely retaliate in opaque ways against US exporters and

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[8] See Kent Troutman, "China Chart of the Week: China's Real Effective FX Appreciation in Perspective," January 23, 2015, Trade and Investment Policy Watch, http://blogs.piie.com/china/?p=4237.

[9] For related analysis, see *Toward a US-China Investment Treaty*, PIIE Briefing 15-1, February 15, 2015, Peterson Institute for International Economics, www.piie.com/publications/briefings/piieb15-1.pdf.

investors.

On balance, the United States would lose more than it gains from withholding full-fledged MES. A very large irritant would be thrown into US-China commercial relations, with a modest benefit to US industries that initiate AD proceedings. Even without the use of surrogate costs and prices, AD margins are typically high. Adding an extra 20 percent penalty, through the use of surrogate cost and price methodologies, will not do a great deal more to restrain injurious imports.

OPENING STATEMENT OF MR. BERNARD O'CONNOR TRADE LAWYER, NCTM

MR. O'CONNOR: I would like to thank the Commissioners for the invitation to be here and for my colleagues who have spoken before me.

As you, Commissioner, said, starting out, she said that China considers that it is entitled to become and considered a market economy. Dr. Hufbauer thinks that it is already a market economy, and Mr. Price thinks it is not. The issue is, though, the interpretation of a provision of the Protocol of Accession of China to the WTO signed in 2001, Article 15. Does it grant MES or does it not?

It's a WTO document, and so therefore it will be interpreted by the WTO, and in that sense, I think we've got to consider ourselves in a pre-litigation phase because it will end up in the WTO at one stage or another. My understanding is that the Department of Commerce at the moment has no intention of changing its current policy, and I think with your support will probably continue with that policy. And, thus, the United States is likely to find itself in court in the WTO at some stage. Whether it's 2018 or later, I don't know.

So really the question I think before you today is what are others doing, and I want to bring something about what the EU is doing and why you need to be concerned about what the EU is doing.

Some background. The EU considers by law, black and white, China as being a nonmarket economy. It is written into our trade law that it is not a market economy. If that has to change, in the European Union, we have to go through a full legislative process. That means a proposal from our Commission and a decision by our two chambers, the Parliament and the Council. To do that will take a year or so.

The Commission, our executive, and the proposer of legislation looked at the interpretation of Article 15 of the Protocol and in an internal legal opinion, which has not been made public, has taken the view that China is automatically entitled to be considered a market economy. On the basis of this, it appears as though the European Commission would propose that China become or be considered a market economy, and we change our law. That was the position before Christmas.

Over the Christmas period and in the new year, there was a lot of pushback against the Commission, all of it shadow boxing because we don't see the actual opinion that the Commission, or the Commission Legal Service has produced, such that the pushback was sufficiently successful to allow a breathing space of about six months in which the Commission has determined too that they will do an impact assessment if they were to change, and that they would do a consultation of the interested parties.

Both of these processes are going on. It will then come to June, July when the Commission will relook at the issue and determine whether they will or they will not go for it, you know, make proposals.

Now, why is this important for the United States in the wider sense, in the wider view? The Commission is not only our executive and the proposer of legislation, but the Commission is also our actor in the WTO. If the Commission were to propose some form of change on the basis of the Article, that we should give China market economy status, it is not very clear that our two chambers--the Parliament and the Council--would agree, and it is very likely that we will be in a situation whereby the Commission would have proposed and the legislative will not have disposed.

In that situation, the European Union will also be "in the dock" in the WTO because presumably if China considers that it is entitled to MES, it will take the European Union to the WTO.

The Commission is the actor for the Community in the WTO. So we would have a situation which the Community might have--or the Commission might have proposed MES, and it might need to defend itself that MES has not been granted. A really rather difficult situation to be in.

But the situation has big consequences for the United States as well. The United States and the EU have been working very hard to try and build a common position on a whole series of trade issues over the last number of years, and let's be honest, there have been difficulties in reaching certain agreements. But it looks as though in relation to the WTO, we're doing rather well. It is most likely that the Community would come in on the United States' side if the United States was the main defendant.

But the United States would be in a situation where it would have somebody coming in on its side that's in an ambivalent situation. So whatever happens, whether it's the United States, which is the first defendant in the WTO case, or whether it's the European Union, should the Commission make a proposal for change, we're all in a very difficult situation.

So for me there is one very clear message that I would very much like out of this Commission, or I mean out of my trip to the States, because in these days, thanks to your invitation, I am seeing a number of other people around town. I mean the obvious thing I would really like is a very clear statement from President Obama that says the US is not, and it never will be, for changing.

I think the chances of me getting that are rather limited, but it is nice to think that it would happen. And if it's not the President, then maybe the USTR or maybe it's the Department of Commerce or some such. And if it's not them, you. Why don't you say it? And I think that what I need from the United States, if you like, is a clear statement that many in the United States do not consider that this is an automatic right that China has, and that China should not be entitled to get it unless it merits it.

What do I want, I suppose, from Congress? I want that Congress also make some sort of a statement of this nature and lets our legislature, our Parliament and our Council, know what is needed, and I see I'm in the yellow thing.

And I think that really the key issue that has to be gone into is have a look at the overall shape of the Accession Protocol. It is a balanced document. China was ruled by a regime at that stage which genuinely did want to open up and make moves. However, the regime changed two years after it acceded. But the overall document says we will let prices be set by the market. It has not happened.

And so China has not complied with many of the commitments that it has made. It is not a market economy. We are going to go to law. We are going to go to dispute settlement over this, and in that dispute settlement, the United States and the EU must stand together so as to be able to stand up to the unfair trade practices which emanate automatically from a nonmarket economy. Thank you.

PREPARED STATEMENT OF MR. BERNARD O'CONNOR
TRADE LAWYER, NCTM

WRITTEN STATEMENT OF BERNARD O'CONNOR
Before the U.S.-China Economic and Security Review Commission
24 February 2016

The underlying EU law and what it takes to change the law

China is clearly defined as a Non Market Economy (NME) in EU law.

Article 2(7) of the basic Anti-Dumping Regulation (Regulation 1225/2009) allows the use of the analogue country methodology for determining Normal Value for NMEs.

If the EU is to change the methodology for determining Normal Value in relation to goods from China there has to be a change in the law. This is why the EU is the first mover on interpreting Section 15 of China's WTO Protocol of Accession.

Changing the provisions of the basic EU anti-dumping Regulation requires a legislative proposal from the EU Commission and the assent of the EU Council (made up of the 28 Member States) and the European Parliament (directly elected by EU citizens). Slightly differently from the US, where there is a difference of opinion between the two chambers of the legislature, the resolution is reached in a *trilogue* between the Commission, the Council and the Parliament.

The EU Commission has indicated that it will make a legislative proposal in relation to China before the summer of 2016. It hopes that the two chambers will be able to reach agreement on the proposal such that change (if that is what is proposed) can be effected before December 2016 or, if not, that the EU will have sufficiently progressed towards change that China would not initiate dispute settlement in the WTO.
This is an ambitious timetable. Normally, in the best case scenario, it takes one year for a legislative proposal to be adopted in the EU. Changing the law in relation to China would not be in the best case scenario.

Among the Member States, only Italy has expressed an opinion against recognizing China as an NME. However, that many other Member States have informally expressed views against granting market status to China. Overall it is difficult to call the issue.

In the European Parliament the second largest grouping has come out against MES and the largest group is moving in that direction.

In this scenario the approach taken by the Commission in its legislative proposal is crucial to the possibility of reaching agreement.

Does the Commission consider China a Market Economy?

The Commission does not consider that China is a market economy.

In 2003 a dialogue was initiated between China and the EU on the nature of China's economy. China sought to show that its economy met the five criteria set out in EU practice to determine the nature of an economy. The five EU criteria are not materially different from those of the US. The five criteria are:

- decisions of firms regarding prices, costs and inputs, including for instance raw materials, cost of technology and labour, output, sales and investment, are made in response to market signals reflecting supply and demand, and without significant State interference in this regard, and costs of major inputs substantially reflect market values;

- firms have one clear set of basic accounting records which are independently audited in line with international accounting standards and are applied for all purposes;

- the production costs and financial situation of firms are not subject to significant distortions carried over from the former non-market economy system, in particular in relation to depreciation of assets, other write-offs, barter trade and payment via compensation of debts;

- the firms concerned are subject to bankruptcy and property laws which guarantee legal certainty and stability for the operation of firms;

- and exchange rate conversions are carried out at the market rate.

In a 2008 report the Commission concluded:

> *The conclusion of this report is that China now has in place almost all the legislation which is necessary for granting of Market Economy Status. That is a considerable achievement. The focus has now switched to the effective implementation of these laws which are crucial for the functioning of any market economy. Market Economy status is assessed on the basis of five criteria. In the judgement of the European Commission, China has clearly fulfilled one of these criteria, Criterion 2 which relates to the absence of state intervention in enterprises linked to privatisation and the absence of non-market forms of exchange or compensation such as barter trade. China has made considerable progress on the remaining four.*

In a 2011 report the Commission did not materially change its views.
In 2013, we understand that China informed the Commission that it did not wish to continue the dialogue. So no further evaluation has been made. It can be concluded that the Commission views from 2008 and 2011 remain the Commission view today.

Thus the formal position of the Commission is that China is not a market economy. In recent months this finding that China is not a market economy has been reaffirmed in numerous statements both from Commissioners and Commission staffers. It can also be seen in the text of the Inception Impact Assessment document (see below).

If China is not a Market Economy why change the law?

A legal opinion from the Legal Service the Commission states that the EU is obliged, on the basis of the Legal Service's interpretation of Section 15 of China's WTO Protocol of Accession, to treat China as a market economy for the purposes of determining Normal Value. This legal opinion seems to be driving Commission thinking on the issue.

The Commission has not taken on board the fact that there are legal opinions which reach different conclusions. Given its importance and the fact that it is openly contested, it is surprising that the opinion has not been made public. The concern is that it is results orientated rather than analytical.

Most importantly, the Legal Service of the European Parliament, in a more detailed and comprehensive analysis, has reached a conclusion different from the Commission and considers that the provisions of Section 15 do not provide that the EU must consider China a Market Economy or clearly indicate what methodologies must be used for determining Normal Value after December 2016.

Neither of the opinions are publicly available. However, the Parliament's opinion has been leaked to the press. And Commissioner Malmström has said publicly that the Commission legal position is that MES must be granted.

What is current Commission thinking?

For the EU Commission it appears that a distinction can be made between the nature of the Chinese economy, is it or is it not a market economy, and the methodology that must be used to determine Normal Value after December 2016.

This distinction is reflected in two documents recently made public: i) an Inception Impact Assessment and ii) an Open public consultation regarding a change in methodology in TDI cases.

The Impact Assessment looks to evaluate the consequences of the different options available to the EU: i) maintain status quo; ii) remove China from the list of NMEs in the basic AD Regulation but allowing, where a sector is NME, use of non-China costs and prices; iii) remove the analogue country approach but re-enforce the normal TDI instruments in various ways. The Impact Assessment is expected for May 2016.

The Public Consultation asks a series of questions to stakeholders on the implications of the expiry of part of Section 15 of the Protocol of Accession as well as the functionality of the changes to the TDI instruments.

Next Steps

The College of Commission will meet during the summer of 2016 to decide what approach to take.

If the Commission proposes legislative change the Parliament and the Council will begin review of the proposal in the Autumn of 2016.

Agreement between the two Chambers will be difficult to achieve.

China is not a market economy

China is not a market economy. China itself calls its market a Socialist Market Economy. It is clear that China is different from the socialist economies in the Soviet Union and Eastern Europe in the 40 years after the second World War. China uses different tools for managing the economy. There are currently 72 Five Year Plans applicable in China at a national, provincial and industry sector level.

These plans have resulted in the massive build up of overcapacities in certain sectors. Bankruptcy and anti-trust laws are not enforced. The ‘market’ is not allowed to function to reward winners and eliminate losers.

Section 15 of China’s WTO Accession Protocol

Here I strongly share the views of my colleague Mr. Price. Section 15 paragraph (d) clearly provides that it is China which must show that it is a market economy. It is not up to the EU or the US to grant it unilaterally. The criteria to be met are those of the importing WTO Member.

The expiry of paragraph (a)(ii) in December 2016 does not mandate the use of any particular methodology for determining Normal Value after that date.

In fact the use of Chinese costs and prices is only mandated if the producers under investigation can show that market economy conditions prevail in their sector.

If China is not a market economy then the use of Chinese costs and prices for determining Normal Value is inherently inappropriate as they are, in fact and in law, distorted by the nature of the economy that gives rise to them.

Section 15 must be read in conjunction with Section 9 of China’s WTO Accession Protocol. In Section 9 China committed to allowing all prices to be set by the market with some exceptions for pharmaceuticals and certain vital services. China has not met that commitment. If prices were set by the market there would be no need for the provisions of Section 15.

The US and the EU

The US and the EU are currently negotiating the TransAtlantic Trade and Partnership Agreement. US industry hopes to benefit from better access to the EU market.

If, at the same time, the EU was to start calculating Normal Value on the basis of Chinese costs and prices it would, in effect, undermine the effectiveness of the EU anti-dumping instrument allowing massive dumping onto the EU market.

In this scenario the benefit that the US might get from TTIP would be undermined by unfair

Chinese trade into the EU.

Conclusions

It is in the interest of the US to ensure that the EU does not grant MES to China. Thus the US should make its legal interpretation of the meaning of Section 15 of the Accession Protocol known to the EU.

The text of Section 15 was negotiated between the US and China. Towards the end of those negotiations the parties agreed that the expiry provisions should only apply to paragraph (a)(ii) and not to all of paragraph (a). This change was to allow the continued use of methodologies other than Chinese costs and prices for determining Normal Value.

The final determination of how Section 15 should be interpreted will be made in WTO dispute settlement. If the US view is to succeed in that forum it is essential that its main trading partner supports its views. The US must now ensure that the EU does not prejudice its position by taking a different view.

Any legislative proposal by the Commission to grant MES or its equivalent to China would already prejudice WTO dispute settlement even if that proposal was not adopted by the EU legislator.

PANEL IV QUESTION AND ANSWER

HEARING CO-CHAIR WESSEL: Thank you, all, for being here. Thank you, Mr. O'Connor, for your travel and appreciate your being here.

Let me ask the question, and I appreciate your comment about the potential or the likelihood of litigation at the WTO and your desire for the U.S. and the EU to have a more common position.

Let me step back and look at this. We are the U.S.-China Commission so our--and not that your question isn't an important one--but I look at it in the shorter term, which is if the EU were to grant China market economy status, what would be the impact on us earlier? And while, you know, who knows whether TPP is going to pass? Who knows whether TTIP is going to, in fact, be finished and submitted?

I'm looking, I'd like to understand from the panel if you're looking at if the EU were to grant market economy status, what would be the implications for products that come from the EU to the U.S.--intermediate goods? So steel that may have been priced differently, let us say, from China to the EU now may be arriving in white goods appliances, that kind of thing, or autos. Help me understand the interaction of those things and what does it mean under our trade laws and how should we be looking at it?

I've heard that some are saying that if the EU were to go forward, we should adjust our market access, our tariff offer in the manufacturing sector in a way to account for what could be lower margins.

So, Mr. O'Connor, if you can start and then others, all the panelists, respond.

MR. O'CONNOR: I think the first thing I'd like to do--we'd move--the previous session talked, quite rightly, about aluminum and steel quite significantly, and I think we need to very much move away from that because it is something much more than just aluminum and steel.

HEARING CO-CHAIR WESSEL: Uh-huh.

MR. O'CONNOR: And there is a very useful report published on the 22nd of February which looks at structural overcapacity in China in six different sectors.

HEARING CO-CHAIR WESSEL: Right.

MR. O'CONNOR: And that's only the six sectors that they examine.

HEARING CO-CHAIR WESSEL: No, no. I mean ferrosilicon. You could go through product after product, agree.

MR. O'CONNOR: So that's it. Now, in terms of pass through, I think there are two ways of looking at it. You're looking at it one single way, which is pass through, and that is goods coming in from China into the European Union being transformed and then passing on.

The rules of origin are such that if there is a significant financial transformation in the European Union, then those goods become European, and even if the European Union has had cheap inputs, they must be able to come to the United States. How to quantify it, I'm not an economist, and I wouldn't do it, but I know it's significant.

I think there is another issue, which is equally as important, and that is TTIP. In TTIP, the United States hopes to negotiate better access to the European market. In return, the United States, or at least the European Union hopes the United States will make movement on public procurement, make movement on pharmaceuticals, on a series of issues that the European wants on its offensive side.

Now should the United States negotiate on that basis, that it will enter the

European market now as it is, and then the European Union market becomes undermined by--if we denude ourselves or weaken our trade defense capacities, then there will be massive dumping. And then overall prices in the European Union go down. And I think United States will not get the benefits that it hopes to get from TTIP. So it's a two-way issue.

HEARING CO-CHAIR WESSEL: Okay. Others? Alan and then Gary.

MR. PRICE: Okay. So Gary may, I'm sure--Gary and I are probably not going to agree on many things today. I would say that as an issue of practical politics, you will see very significant concerns on both sides of this, that there will be, in essence, increased inputs brought in from China that are incorporated into Chinese goods, into European goods, origin changes making them even sort of hyper more competitive in the U.S., thereby causing significant increased access, indirect access from China.

The flip side of that is the value of what we think we're going to gain from access will be lower. I have little doubt that there will be very significant requests to realign the proposals for concessions from Europe and in a way that may make it more difficult to reach an ultimate agreement on TTIP if--

HEARING CO-CHAIR WESSEL: I'm sorry. You say from Europe. That Europe would ask for--

MR. PRICE: No, it would be the United States.

HEARING CO-CHAIR WESSEL: Okay.

MR. PRICE: I mean it always depends on the administration. We're at a difficult time politically to figure out where things are going, but I would say that as a matter of straight-out politics, a number of people out there recognize that this will have profound economic consequences, and one would expect that the requests from the United States will increase and change and therefore it would make an agreement much more difficult to reach.

HEARING CO-CHAIR WESSEL: Gary.

DR. HUFBAUER: Well, Alan is right, that I find it hard to agree with him, but I don't find it hard to agree with one point at least that Bernard made, and that's this: if the U.S. decides to deny China market economy status, then it would be wonderful if the EU, Canada and Japan would have the same view because otherwise, for sure, anything that can be purchased here and purchased at a reasonable price there will instead be purchased there, starting with Airbus but moving on to a whole host of other goods. So to stand out alone would be I think commercially foolish.

Now, on the indirect or pass-through rule of origin: for the United States, assuming that other countries do grant China market economy status, for the United States to suddenly come in and rejigger its rules of origin would create a whole host of litigation with lots of countries. This will be great for K Street lawyers; it won't be great for the United States.

HEARING CO-CHAIR WESSEL: Thank you.

HEARING CO-CHAIR CLEVELAND: Commissioner Bartholomew.

VICE CHAIRMAN BARTHOLOMEW: Thank you. Thank you to all of you, those of you who traveled distances and those of you who are around the corner.

Mr. O'Connor, I just want to start with--I want to make sure I understand something. As you were talking through the process between the European Commission and the European Union, it is that the European Commission would conceivably have to defend a position at the WTO that's not its own. Is that what you were saying?

MR. O'CONNOR: Sorry. No. No. The Commission is the initiator of all legislative action in the EU. So the Commission might go and propose that we should give market economy status to China.

VICE CHAIRMAN BARTHOLOMEW: Right.

MR. O'CONNOR: And there is a good possibility that that is what it will do or certainly it's our concern that it will.

Now, it is also possible that our legislature will not agree. So we will have a legislative proposal out there saying we must, and we have no action. So in that situation because our law clearly says today that China is not a market economy, we're in status quo but with one thing extra: the Commission will have said we think we should change.

So that's our position. Then when we move to the WTO, there are 28 European Union members of the WTO, but it is the Commission, by common accord, which is the actor in WTO disputes and in discussions. So we would have the situation where the Community or the Union would not have changed, and so it would continue to think that China is not a market economy, and China would attack or take a case against us, and it would be the Commission who would be defending the European Union.

VICE CHAIRMAN BARTHOLOMEW: Right. So the Commission would be obligated to defend the European Union's position even though it might not be its own position.

MR. O'CONNOR: That's exactly the situation.

VICE CHAIRMAN BARTHOLOMEW: Is it lawyers who are doing this?

MR. O'CONNOR: It would be lawyers who--

VICE CHAIRMAN BARTHOLOMEW: So they're good at arguing the opposite side, whether they want to or not?

[Laughter.]

MR. O'CONNOR: Well, it would be the very same lawyers who have taken the view--that we haven't yet seen--that we have an obligation to do it on this unseen legal opinion that certainly a number of us at this table consider is a mistaken opinion.

VICE CHAIRMAN BARTHOLOMEW: Okay. I'm going to put out to all of you what I think is the biggest challenge of the day, which is to explain why this matters in non-technical language. If I am sitting out somewhere in this country, and I am not a trade policy expert, why should I care about whether China has nonmarket economy status or market economy status?

DR. HUFBAUER: Let me jump in on that. First of all, the nonmarket label is calling China kind of a bad guy. So that's part of it. More importantly, it's the difference in penalty duty that would be imposed in a countervailing duty or antidumping suit against Europe or against Mexico, and the penalty duty that would be applied against China under nonmarket economy rules. It's that difference.

The problem is we don't know what that difference is because we've handled all cases since the inception of China as a member of the WTO and before as nonmarket economy cases. So we don't have an alternative track record. I'm suggesting that a hypothetical track record could be created. I don't think the difference in penalty duties would be huge, but the nonmarket economy duties would be higher.

VICE CHAIRMAN BARTHOLOMEW: So my brother lives in New Mexico and does not know what a countervailing duty is. Again, is there a way to translate this, Mr. Price?

DR. HUFBAUER: It's a penalty. It's a penalty.

VICE CHAIRMAN BARTHOLOMEW: A penalty.

MR. PRICE: No, it's actually not a penalty at all. And this Alan Price here.

[Laughter.]

MR. PRICE: It's not a penalty at all. It is a margin that corrects for the distortion due to subsidies or due to dumping. Dumping exists because the Chinese market is fundamentally distorted. The margins out of China cases are very substantial. Commerce constructs those margins using market inputs and the actual factors of production. As you heard Mr. Ferriola just explain to you a little while ago, those costs are dramatically different. If you value them on a market basis, China would not be competitive.

They would not be competitive in a whole host of products. China wants to basically continue its process of highly subsidizing industry after industry, whether it is through central or provincial, and we can argue how the problems exist, but you have this massive overcapacity that is ultimately distorted by the financial system and banks and the government and inability to force companies effectively out of business, which creates lower prices and money-losing enterprises that just get prompted by and supported with ever-lower prices and more subsidies to keep them alive.

Producers in the rest of the world have to earn capital. They just can't compete against those prices so they fold their tents. This is about essentially keeping the field fair and level, and if you don't use--and the principal tool has been the dumping law and the principal tool has been--and what makes it effective is nonmarket economy status, and this is why in China, it's always its number one, two, or three request in any economic negotiation.

And the reason why people treat them as a market economy in the couple cases they have is because it’s their first ask in an FTA, their first requirement, they won't negotiate with you unless you treat them as a market economy.

VICE CHAIRMAN BARTHOLOMEW: Mr. O'Connor.

MR. O'CONNOR: I reckon your brother in New Mexico knows what a market is.

VICE CHAIRMAN BARTHOLOMEW: Yes.

MR. O'CONNOR: And will know that in the U.S. market, we have rules and regulations to make sure that the market remains healthy. So we've got anti-competition or antitrust. We've got anti-monopoly laws. We've got certain types of laws which frame the conduct that can be--that makes for a healthy competition and a healthy market.

Our tools on the international level are not really as sophisticated as those antitrust rules and anti-monopoly rules. However, they try to address the same sort of issue. They try to address the issue of elimination or countering what's not elimination. What they try to do is counter some of the negative effects of improper behavior in the marketplace.

And the two improper behaviors are dumping, which is selling at below your cost of production in the export market, and subsidies.

VICE CHAIRMAN BARTHOLOMEW: Okay. Thank you. That's helpful.

Dr. Hersh.

DR. HERSH: To put it in simple language, an economy is built around rules, and the rules matter a lot for who's going to win and who's going to lose in an economic interaction. And what we have in this situation is where China is playing by unfair rules. So the measure that was incorporated into the WTO Accession Agreement was an attempt to level the playing field of competition to make the rules more fair, to hold China to play by those rules.

And the cost of not playing by those rules has been substantial for the United States. Estimates of job losses from import competition from China since 2001 are about 2.5 million jobs. And it's not just in industries that are directly affected by where China has overcapacity--steel, aluminum, et cetera. When these job losses happen, when a factory closes, the effects ripple across a whole regional economy.

There's wage growth stops. Unemployment rates go up. Local government budgets get strapped because so many more people are demanding the public services so it really doesn't--it really affects across whole regional economies, and that's what the big issue is at stake here.

VICE CHAIRMAN BARTHOLOMEW: So I want to emphasize what you said about that 2.5 million jobs because I was on the Hill when we were going through this debate, and China's accession to the WTO was supposed to be creating great economic opportunity for the United States, and yet the result that you say is that in our communities we have lost 2.5 million jobs. That's not to say that some jobs haven't been created, but I think the perception among a lot of people, and we've seen this reflected in our political process, is that the American people lost in this process.

So I will have questions if there's a second round.

HEARING CO-CHAIR CLEVELAND: Okay. Commissioner Shea.

CHAIRMAN SHEA: Thank you all for being here. I'm actually enjoying this panel.

[Laughter.]

CHAIRMAN SHEA: It's hard to believe. I wasn't expecting to. Now, Dr. Hufbauer, my understanding from your testimony is that you think there are greater policy and commercial reasons for the United States to grant market economy status to China regardless of the legal standard, but even, as I understand you, even if you look at the economy, you think substantively the Chinese economy deserves market economy status. Is that generally correct?

DR. HUFBAUER: Yes.

CHAIRMAN SHEA: Okay. Now, I hope you'll indulge me. Okay? You and Dr. Price. Because under our law, the Commerce Department gets to decide, right, whether China meets this test, and there are six factors--well, let's reduce it to five factors for ease, and I was wondering if we can go through each of those five factors, and each of you give me your best shot as to how you would, how you would answer?

VICE CHAIRMAN BARTHOLOMEW: Make the case.

CHAIRMAN SHEA: Make the case. So we have an economist and a lawyer. So maybe we'll downgrade the lawyer a little bit since he's got an advantage on the final score, but, okay, first, is the economy--is the currency convertible? Dr., Mr. Price, give me your best, and then Dr. Hufbauer.

MR. PRICE: So there are still very significant controls on currency in China, and those controls continue to influence the value of the Chinese currency, and they continue to exert very tight control over the RMB exchange rate.

CHAIRMAN SHEA: Okay. Dr. Hufbauer, how would you?

DR. HUFBAUER: Yes, it is, and it is convertible now.

CHAIRMAN SHEA: Okay.

DR. HUFBAUER: And they do allow outflows of currency, and that's been one of their problems lately because there's been too much outflow so the People's Bank has been supporting the value of the currency, much to the pleasure of Treasury Secretary Lew.

CHAIRMAN SHEA: Okay. Next point. Are the wage rates--

VICE CHAIRMAN BARTHOLOMEW: Wait, Dennis.

CHAIRMAN SHEA: I'd like to set up a debate--set up--are the wage rates--I'm sorry, Dr. Hersh. But are the wage rates the result of negotiation between management and labor? Mr. Price?

MR. PRICE: So the answer to that is largely yes. There are still a variety of restrictions on labor movement that exist in China and that exist out there that do distort wage rates, but largely yes.

CHAIRMAN SHEA: Okay. And Dr. Hufbauer.

DR. HUFBAUER: We're in agreement.

CHAIRMAN SHEA: Okay.

DR. HUFBAUER: It's amazing.

CHAIRMAN SHEA: I'm surprised. I thought Mr. Price would push back a little harder on that one.

HEARING CO-CHAIR CLEVELAND: Maybe you could add Mr. Hersh in, Dr. Hersh in here, and see what--

CHAIRMAN SHEA: Okay. Dr. Hersh, you want to--sure.

DR. HERSH: So on the exchange rate we have free convertibility for trade transactions. That's a requirement for being a member of the International Monetary Fund. It's been that way for a long time. Where there's the most dynamic area of this is in the convertibility for capital account transaction, financial transaction. This is in a great deal of flux as China has responded to the market gyrations and the problems of the capital outflows.

But the exchange rate mechanism is still highly managed, and I provide some econometric evidence in my written testimony that it pegs to the dollar. About 90 percent of the basket is pegged to the dollar.

Wages, most of the wages in the economy, are set in some degree of bargaining between the workers and managers, but that happens in a very constricted environment of labor rights, where there's only one official trade union. That union does not represent the interest of workers. It represents the interests of enterprises and managers. The workers' voices are not heard in setting priorities for negotiation or for electing their representatives.

CHAIRMAN SHEA: Okay. If I may continue, there are three more. Is there extensive restriction on foreign investment? Mr. Price. We'll just go down.

MR. PRICE: So the answer is yes, depending on the sector. Some sectors are banned. Other sectors are restricted to 50 percent investment. It varies by sector, but it is extensive, and China continues to regulate foreign investment very closely, particularly in key sectors, such as financial services, which are largely closed to foreign investors or are available under very tight controls and conditions.

CHAIRMAN SHEA: Okay. Dr. Hufbauer.

DR. HUFBAUER: China is not nearly as open as we would like, as we discussed in the book that was referenced, Bridging the Pacific, but it is more open than almost any other emerging country and has more foreign direct investment by far than any other emerging country. So it's more the glass half full than half empty, but there are important sectors which are blocked, for example, telecom. Banking is only partly open. Insurance is open to a very limited extent, and I could go on, but by comparison with a country like India, China is wide open.

CHAIRMAN SHEA: Okay. And then I'll combine the last two. To what extent is there government ownership of the means of production and to what extent does the government control the allocation of resources?

MR. PRICE: So the government controls many of the means of production through ownership. A very large portion of the Chinese economy is still owned by central and provisional SASACs. And it's very interesting when you actually trace control because you have this whole discussion of what private ownership is in China. A lot of private ownership, for example, from the labor union, is really the company management because it's actually still the State Council and the state government.

And so key sectors, key producers, when you look at it, about 50 percent of the economy based upon the reports we've seen and the analysis we've done of the steel sector and of the aluminum sector and many other sectors are actually dominated by state control of the production means, both directly through ownership, but also through the way the state banks allocate loans and capital, and there's tremendous use of loans as a means of manipulating and maintaining the system in China.

Also, in terms of pricing, not only does China by keeping industries and companies in business and continuing to finance businesses essentially drive pricing to levels that markets don't recognize. And, in fact, the Chinese State Council on overcapacity actually recognized that this was one of the great failings as to why Chinese prices are completely distorted and the market is completed distorted. That was a 2013 finding.

CHAIRMAN SHEA: Okay.

MR. PRICE: Finally, they actually do intervene directly in prices. Aluminum is actually a great example where three times in the last five years, they have intervened in the aluminum market, and despite massive overcapacity and no reason for stockpiling for any strategic reason, buy aluminum from state producers at more than at market prices in order to prop them up and keep them alive and keep the market pricing distorted.

CHAIRMAN SHEA: Dr. Hufbauer. This is it.

DR. HUFBAUER: Let me read just one sentence from Mr. Price's testimony--the Chinese state continues to own a substantial portion of the Chinese economy. Two recent studies estimate that state-owned entities account for approximately 50 percent of Chinese GDP.

I don't know who the authors of those studies are, but they do not match up to Nicholas Lardy who wrote the book from Mao to Market. Read that book. Look at the data. You can look at a single chart, but he's got it all referenced, and the Chinese state ownership has declined from the 85, 90 percent range at the beginning of the Deng era to about the 25 or 20 percent range now.

So there's been a huge transformation of this economy. You can list a number of industries where Chinese firms are predominantly state owned, and I don't disagree with that, but that's not the majority of the economy. That's the important point.

The second point, a supplementary point, is that, and here to his embarrassment, I'm agreeing with Mr. Price.

[Laughter.

DR. HUFBAUER: But the state banks, there are four state banks, and they really do control the allocation of a lot of capital. And they roll over the loans in a non-commercial fashion. So that is a major tool that is still in play.

CHAIRMAN SHEA: Thank you. May I just call on Mr. O'Connor? I know I'm way over time, but--

MR. O'CONNOR: I'm sorry to step in on this, and it's very interesting, but the last one is, I think is the most important. It's the allocation of resources. That is the key issue in the market where the market allocates the resources through competition, through bankruptcy, through whatever. It doesn't happen.

There is a study from the summer of 2015, the Taube Report, which shows that there are currently 72 five-year plans in operation in China today. These five-year plans are such that they define objectives, and if you are in an objective that is favored, then you get a whole series of benefits. If you are not, you don't.

So it is very much a controlled system, and what we find is that the enterprise does not respond to the market. Enterprise responds to the five-year plan, and it means that if the five-year plan wants employment and the five-year plan promotes market share because the more market share, the more benefits you get under the five-year plan. So it's the five-year plan system, and there are 72 of them, which distorts and allocates resources.

CHAIRMAN SHEA: Well, thank you for indulging me. I think we're going to have to wrap it up unless the co-chairs want to--

DR. HERSH: So if I'm not mistaken, this 25 percent figure you cite from Nicholas Lardy is referring to the 117 central government controlled, SASAC controlled state-owned enterprises. The state-owned sector is much more extensive than this, and many more of the enterprises, the investment and the employment actually happens at lower levels of government.

And through a series of corporate governance reforms in China since the mid-1990s, a lot of these transformed into things which are not so easy to identify as government-invested, government-owned enterprises.

A really good example of this is Zumlion Heavy Industries, which has been making a lot of news lately with its takeover bid of Terex. Zumlion used to be a department of the Hunan provincial government. In the late '90s, it was transformed. It was corporatized. It became a stockholding company. The shares were given out to officials in Hunan Province and managers of the enterprise who were also at that time Hunan Province officials.

Through a series of additional corporate governance reforms, they restructured themselves offshore, had a Hong Kong IPO listing, and then all of a sudden all their assets in the Chinese mainland are considered a foreign-invested enterprise even though Hunan government--and because they absorbed some of the state, central state-owned enterprises that had been shed as part of the shrinking to 25 percent, SASAC actually owns shares in Zumlion Industry now. And that's not so easy to tell if you just look at the statistics in China's statistical yearbook. To understand who's controlling these, you have to go through the financial filings if you find a company that happens to have an IPO in an offshore market where such disclosures are mandated.

CHAIRMAN SHEA: Thank you.

HEARING CO-CHAIR CLEVELAND: Wow.

[Laughter.]

HEARING CO-CHAIR CLEVELAND: Senator Goodwin has a question, but I think Carolyn's point of how do we simplify this debate in a way that makes it meaningful to the American public, I think if we get--I mean this is fascinating, but I think if we end up trying to explain to the American public the difference between SASAC supervised or regulated enterprises versus local government financing vehicles or whatever the terms of art, I think we get, I think we lose that debate in the country.

I'll defer to Senator Goodwin, but I really am interested in this morning's conversation about definitions of what--

VICE CHAIRMAN BARTHOLOMEW: Private non-private.

HEARING CO-CHAIR CLEVELAND: --constitutes a state managed, controlled, supervised, influenced enterprise versus what we in the United States understand as private enterprise. But I'm going--sorry. I'm just putting that out there because I'm puzzling through it.

Senator Goodwin.

COMMISSIONER GOODWIN: Thank you, Commissioner.

Just to follow up on the legal debate, I had one quick question. So this determination of whether China should be treated as a market economy is a question of our national law, and it was suggested by one of the panelists, and my apologies for not recalling specifically who it was, suggested that that determination could be made potentially on a sector-specific basis, sector-by- sector, and mix-and-match approach, I think, Doctor, as you described it.

My question is, is that legal? I think, Doctor, you raised some concerns as to whether the WTO would sanction such an approach and think it is appropriate. So I open that question to the panel.

DR. HUFBAUER: Well, since you referred to my suggestion, my guess is that the WTO would not sanction it, but I think it's a very close legal question, given the Jesuitical nature -- remember, I was a professor at Georgetown University --the Jesuitical nature of the Protocol of Accession, which the WTO Appellate Body will read very carefully. They'll go into all the notes and history, and I think they'll say you can't slice the baby. It's either nonmarket or market, but I may be wrong on that. In terms of what the U.S. can do, I don't see any reason that the U.S. cannot do the mix-and-match approach.

MR. O'CONNOR: If you look carefully at paragraph (d) of Article 15 of the Protocol of Accession, you see there are three sentences. The first sentence says if China can show according to the criteria of the importing member that it is a market economy, well, then, there are a whole series of consequences. First sentence.

Second sentence then says it is the one that disappears, that expires.

The third sentence says if China can show for a sector of the industry, of the economy, that it is a market economy, well, then you apply market economy conditions to that sector. So it's in black and white in paragraph (d) of the Protocol of Accession, Article 15, Protocol of Accession.

MR. PRICE: So let me just add the following, which is--first of all, I agree with Bernard. The fact is that this will probably be an issue of dispute resolution no matter what happens here. The Canadians have already changed their law from granting automatic market economy status to not granting it and essentially aligning themselves with the U.S. Mexico is aligned with the U.S. The Brazilians informally want to align with the U.S. on this issue.

Europe is obviously very concerned about it. Our Japanese friends are very concerned about it. This is ultimately a very--this is ultimately a technical legal question under--and we can all talk about the Vienna Convention of Treaties and how we all go through that, and rather than, rather than sort of have a detailed discussion of that, what I would say is that under the law right now in the United States, a company can come in, an industry sector can come in and say we ourselves are not a market economy and therefore get a separate determination.

The last time anyone has come forward in this issue in the United States was in 2006 in a case that I handled, and the Commerce Department decisively decided that China is not a market economy. The Chinese government has not come forward since then. A Chinese company has not come forward since then to ask that question. The Chinese industrial sector has not come forward since then.

China could come forward today if they thought they would actually meet the standards. They have not come forward. They have not come forward in the U.S. to ask for it. They came forward I think about 2--

MR. O'CONNOR: 2003 in the European Union. The European Union gave a report in 2003. China requested the EU be considered a market economy in 2003. 2008, the Community rejected it. 2011 it rejected it a second time, and then in 2013, China withdrew from the process of requesting.

MR. PRICE: Bottom line is I think China recognizes that it does not meet the standards that the U.S. has, that Canada has, other countries have to actually be considered a market economy. And so therefore its only argument is, is because this one sentence withdraws one provision of the Protocol but leaves the rest of the Article 15 in place which allows nonmarket treatment, does that somehow or other give us a legal right even though we're not really entitled and don't meet the standards?

And to me I'm happy to litigate an argument like that because they are in the wrong on this because they are not, they have not followed through on a whole bunch of their commitments. They are not functioning as a market economy, and I think we have a reasonable case under the Accession Agreement to defend the U.S. position, as do I think many of our trading partners.

COMMISSIONER GOODWIN: Thank you.

HEARING CO-CHAIR CLEVELAND: Can I clarify on--maybe you can answer this part of it. I heard you ask not just as a country but by sector as well.

COMMISSIONER GOODWIN: Right.

HEARING CO-CHAIR CLEVELAND: Yeah. So your response was as, both in the EU and when Commerce opined, that it was the country that sort of put the feelers out. Was there a sector?

MR. PRICE: U.S. law is very clear. I'm not going to opine about EU law because there's actually--we can talk about the exact requirements of the Protocol in sickening detail and argue what they mean. But U.S. law is what we apply here, and the U.S. law actually says that you can come through any one of those bases. You can request on a sector.

HEARING CO-CHAIR CLEVELAND: I was asking you what they did, not what--

MR. PRICE: In that case, they looked at it as the economy as a whole. There wasn't really, there wasn't a material argument put forward that that sector in particular was somehow or other different. There has been one case where they did find an individual company was, in fact, a market- oriented company in the United States and therefore did receive market economy treatment.

That was, that was probably in the--I don't know--late--early--early 2000s, late '90s, but U.S. law is flexible and U.S. law actually currently meets the WTO standards of Article 15 going forward.

HEARING CO-CHAIR WESSEL: And it's a facts-and-circumstances test that the respondent can seek to apply; right?

MR. PRICE: Exactly. So they can seek to apply this. And they're just not seeking, seeking to do so, and I think that speaks a lot because, believe me, our Chinese friends in case after case are very active in litigating these cases. They're not, you know, they're not ill-advised. They hire some of the biggest and best law firms in the world. They're defended by more K Street law firms in Washington that defend U.S. industries, both in here, and they defend them in Geneva at the WTO.

HEARING CO-CHAIR CLEVELAND: Please.

DR. HUFBAUER: I agree again with part of what Alan said. Namely, that there is a reasonable reason to think the U.S. might prevail. However, drawing your attention to the one sentence in Article 15(d), which I know was very heavily negotiated by China. This is not some throw-away. It was heavily negotiated. That sentence reads: "In any event, the provisions of subparagraph (a)(ii) and the whole shall expire 15 years after the date of accession." And in the Chinese view--I'm not representing China--but in the Chinese view, that sentence away with everything else.

That gave them market economy status on December 16, 2016, and now the burden of proof in legal terms will switch to those who would deny it market economy status. Big switch. Now, more than once Alan has said "a single sentence." May I remind you that the First Amendment has a single important sentence.

HEARING CO-CHAIR CLEVELAND: Commissioner Bartholomew.

VICE CHAIRMAN BARTHOLOMEW: Thank you.

An observation and maybe two, and then a question. The observation, Mr. Price, I'm glad you mentioned comparative advantage. I have wondered over the course of the past five or six years in particular whether Ricardo's Theorem is even valid anymore. And yet it seems to be the paradigm under which our trade negotiators work almost generation after generation, and I think that's sometimes to the detriment. I'm just not convinced it holds any reality anymore.

Another observation, Dr. Hufbauer, too, which is that China has had a tendency, I mean it engages in something we call lawfare. I mean it has a tendency to always interpret the law in its own interests rather than necessarily--I'm thinking of the U.N. Convention on the Law of the Sea, all of these. There's a bunch of these where it's doing it.

So you make an interesting point about that, but China does what's in China's interests, and I think it's important for the U.S. to do what's in the U.S.' interests, and I think sometimes we put global interests ahead of our own interests.

But my question is how much has China changed the WTO? Again, going back to the accession debates, the argument was bringing China into the WTO will change China. And indeed there have been some changes, but I'm going to refer to our former colleague, Pat Mulloy, I mean who would say that, you know, the WTO is a dispute resolution mechanism, but somehow now China has made it so that bringing a case at the WTO is a hostile act.

And I wonder how much you see, if any, that China's participation in the WTO has actually changed how the WTO works?

MR. O'CONNOR: I think there's no doubt that the European Union, for one, is always concerned about retaliation from China. Now we're not talking about retaliation in the strict WTO sense whereby you go through a process and you're allowed to put in duties against, on a particular amount.

But there is quite clear--I will give you an example. The European Union lost a case on fasteners on the 18th of January. On the 17th of February, so last week, the European Union proposed to annul certain measures that were found incompatible. Now that's a five, four week, four week process, and that's only done out of concern that somehow some big bad bogeyman was going to come in out of the sky and whop the head after Europeans. I really can't explain why.

But that is a serious problem that we have in the European Union. Now I heard in the previous session many calls for the United States to stand up. Now we look from, you know, faraway hills are green, and we look from Brussels over to Washington, and we think, man, if we could only be as strong as that.

[Laughter.]

MR. O'CONNOR: And yet then I see you worrying about the lack of enforcement of rights, but that is a real example. So 18th of January a judgment comes out. On the 17th of February, the proposal is put to change the rules.

VICE CHAIRMAN BARTHOLOMEW: And an example perhaps of a judgment against the Chinese and how long it has taken to implement that on the Chinese part.

MR. O'CONNOR: Well, I would come back, can I, just before you come in there, Alan? There is a very, very good article in a peer reviewed law magazine that just came out two weeks ago--by a Chinese academic--saying, explaining how China is better at playing the rules than we are--certainly the European Union. And saying that it has--what it does by WTO dispute settlement is buys time. In the process, then, it does whatever it needs to do to reform, and then when the judgment comes out against it, it is usually not too difficult for China to comply.

MR. PRICE: I'll come out real quickly with two quick examples. One is Rare Earths where I did a lot of work for essentially the complaining party preparing the case. Chinese government officially brought themselves into compliance. There were a variety of export restrictions that existed so they eliminated those WTO-inconsistent export restrictions.

There were 30 Rare Earth companies--they consolidated them--many of them independent that were actually selling out into the open market quietly. We can talk about how things work in China because things that don't happen still get exported sometimes. They didn't like the fact that there were some exports--they had to bring themselves into compliance with the fact that their official export bans were found to be WTO inconsistent. And this is all for nationalistic military purposes. Let's just be blunt about this.

They consolidated those 30 companies into three SOEs. They don't have to worry about formal controls anymore on the exports on Rare Earths. So they're in formal compliance, but they have brought themselves into compliance in a way that I don't think a legitimate market-oriented country would have done so.

I'm aware of another dispute where essentially we had third-party support from a small, smaller country, very dependent upon agricultural exports to China. They filed a brief in our favor, and literally in the middle of the dispute resolution, their lawyers were told to sit down and do nothing to support their brief and not say another word because China had essentially called up and said we're canceling your contract for commodity X if you continue this, and that commodity was probably worth essentially 25 percent of their exports. So devastating. So China plays hardball in this stuff.

So it's changed that process in a very, very significant way, and I think there are other ways it's actually changed the dynamics within the WTO. And then Terry and I could talk to you about issues about WTO dispute settlement and the problem frankly.

Part of the problem is binding dispute settlement because it has actually eliminated negotiation, which is probably the way that--I think one thing and Mr. Hufbauer and I might agree with is that in the long-run, negotiations are actually desirable and tradeoffs are actually desirable.

But the whole dispute resolution system has really--has really made that very difficult, and China is essentially exploiting that to the maximum extent it can and will only come to the table when we force them to come to the table.

We've heard about ways of getting to the table. I'll give you two more. I think we're going to see those if you ever see--if you see a Trump administration, he's going to have to justify everything he does under IEEPA in Section 232, which are actually the statutes that in many cases President Reagan used to force Japan to the table. Sometimes it takes bold moves.

I'm not endorsing a candidate. Don't get me wrong there.

HEARING CO-CHAIR WESSEL: Are you talking about Reagan or Trump?

[Laughter.]

MR. PRICE: Perhaps either, but there are other tools out there, but they're even more blunt and more significant. This is the most common tool used, and it's critically important.

HEARING CO-CHAIR CLEVELAND: Commissioner Tobin.

COMMISSIONER TOBIN: Thank you.

I have a question. I'm not trained as a lawyer or economist. So as I walk away from this panel on nonmarket economy status, a question that comes to mind is why are our antidumping and countervailing duty laws more efficient or effective if we treat China as a nonmarket economy rather than a market economy? Doesn't it net out to that? And maybe each of you have an opinion on that.

MR. PRICE: So very quickly, essentially, the series of distortions are so great in China that the internal prices and the pricing mechanisms that exist essentially are not set by what we would call reasonable rules of the road that would allow markets to function, including exits of enterprises that should be exited, not bailing out and continuing to--bailing out companies and continuing to drive prices lower and lower.

As a result, you just don't have a system that works. Prices are so depressed that essentially companies, regardless of what industry you are in, can't compete against the China price, just can't, and it's because of the degree that the system is so different than ours and continues to be so different than ours, and until fundamental reforms really take hold, and we all want to see those reforms happen, there has to be an offsetting mechanism to adjust the prices so that they reflect what real costs are.

And we're talking about using the costs in Thailand or Mexico in our system to understand what those costs factors should be. And so it is essentially an issue of making sure that those prices and costs and the dumping calculations reflect some form of non-distorted market reality.

COMMISSIONER TOBIN: So you're saying it's more effective if we treat them as a nonmarket economy?

MR. PRICE: Correct.

COMMISSIONER TOBIN: Dr. Hufbauer, please.

DR. HUFBAUER: Yes. Thank you very much.

I'd like to first revert to the prior question, which was the hardball question on China. Yes, it's true, China does play hardball, and so do we. Look at what's happened with the COOL adverse decision against the U.S. The Congress has gone back a couple of times. Look what happened with the gambling case Antigua brought. Look what happened to the cotton case. You know, we're big countries; we play hardball. We don't always agree with the WTO decisions, and the Chinese don't always agree with the decisions, and they try to work around them.

I don't think in the hardball league, you would find a lot of difference between China and the U.S. Several years ago, we did a very thorough analysis of this question. I haven't tried to update it. Other things have been on my mind. But it looked like about equal amount of compliance with WTO decisions, which is not 100 percent compliance, but it's surprising how good the Chinese compliance is, in my view.

And it's surprising how good the U.S. compliance is. We often comply with decisions which are painful to us. The question at hand is the difference--I'll spare you the contrary speech to what Alan just said about how distorted China is. I'll just put it into one sentence.

COMMISSIONER TOBIN: Yes.

DR. HUFBAUER: I mean if you look at the Chinese economy, it has come further and faster to a market capitalist economy than any economy in world history. This is amazing since Deng came in, you know, it's only 30 years, and today China is a capitalist go-go economy in many respects. You can't say that of India. You can't say that of Japan.

Alan uses the word "distortion" often. Yeah, there's distortion. We have distortion here too. But I don't think China has more distortion than any other major emerging country. In fact, it has a lot less than Brazil, just to take one big example.

COMMISSIONER TOBIN: Yes.

DR. HUFBAUER: Now on the specific question, what difference the nonmarket economy designation makes. There has been good statistical analysis of duties trying to adjust for other factors when you have a nonmarket economy designation as opposed to a market economy designation. The world's leading economist on this question, now at the World Bank, is named Chad Bown, B-O-W-N, and he has a big database, the biggest in the world, and he's looked at this question. So you could call him up and ask him to give you an estimate of the difference.

My recollection is that if you give a country a nonmarket economy designation, trying to control for other factors, you get an additional antidumping margin in the 20 to 30 percent range on average. You get an additional margin.

Now is that accurate? I was actually in the Treasury when the nonmarket economy concept was invented by my colleague, unfortunately passed away, Peter Ehrenhaft, in the Polish golf cart case, long ago and far away. The difference depends on the characteristics of the surrogate country that determine the costs or prices you use. Are they better than the ones in the country where the case is brought--the prices, the wages, electricity, and so forth. And you get some bizarre examples. Others are more reasonable.

I think it's just really hard to make a good generalization. Maybe when you do a nonmarket economy analysis, you choose prices and costs of factors in production in another country that isn't very competitive in the market in question. And you get a bizarre result.

COMMISSIONER TOBIN: I see.

DR. HUFBAUER: So you end up with a higher dumping margin.

COMMISSIONER TOBIN: Mr. O'Connor, I can see you have a thought, too. Thank you, Doctor.

MR. O'CONNOR: No, I would just like to make two points, one as to what Adam Price has said. If, normally dumping, in particular, is the measurement of the price in the country of origin as against the export price to the country of destination. And you need to have a fair comparison between those two to know what the dumping margin is.

Now, if one of those factors, either on the normal value in the country of origin or the export price, are distorted, then you have to make adjustments. And that's what this is all about.

When you define a country as a nonmarket economy, you say that per se the prices, the normal value, the price in the country of origin, is inherently distorted and is not usable. What do you do to replace it with? Now this is not an easy thing. It really is not easy. But you have to find something that is market oriented.

And how you find that market orientation, there will always be mistakes. And so therefore saying what the difference will be, 20, 30 percent, is a very tricky science. It's not a science. You cannot do that because always when you, when you are dealing with a nonmarket economy, you have this problem of what do you replace with to find the thing?

So be very careful. What our guts tell us very simply is that if we were to give China the status of market economy when it is still a controlled market economy, we will not be able to have an effective antidumping system or instrument, and it won't work.

The issue also, by the way, is not only in relation to those areas where we traditionally have a lot of antidumping where we will be talking about steel, aluminum, and these sort of things. The other very important aspect of a healthy instrument is the deterrent effect, and there is no doubt that it is a very important thing, knowing that you can be subject to antidumping and that does deter a lot of--

COMMISSIONER TOBIN: So it's a tool politically?

MR. O'CONNOR: It has a political element as well. But it is a technical instrument to address a specific type of unfairness.

COMMISSIONER TOBIN: Thank you.

Dr. Hersh. Thank you.

DR. HERSH: I think there are two questions tied up in here, Commissioner. One is do prices in China behave or are they set on a market basis? And the second one that Dr. Hufbauer has been talking about is are there appropriate reference prices in other economies to use as surrogate prices when calculating these dumping margins?

But to the first question, which is relevant to whether China satisfies the market economy criteria, in my written testimony, I include some econometric analysis that actually looks at how prices in China behave for specific commodities, and I'll point you to the example of coal prices, which is a major input for electricity, which everyone in China uses, as well as steel and other industries.

And what's really interesting about this is you can see that the China price really drives world prices, but changes in world prices do not have a reciprocal effect on coal prices in China, and that's true of coal--

COMMISSIONER TOBIN: Interesting.

DR. HERSH: That's true of a number of steel products and iron ore. Some products you can see in China that they follow world market prices--copper is one. And some commodities, you can see they have almost no relationship for the world market prices, like rice, for example, which makes sense because China has endeavored to be food independent and doesn't really import rice, so their market is completely segmented from world market.

COMMISSIONER TOBIN: Thank you.

Madam Chair, this is--

VICE CHAIRMAN BARTHOLOMEW: Just quickly, which is on the issue of retaliation. Although this is not a WTO issue, I can't resist raising the fact that it's been five years since Liu Xiaobo got the Nobel Prize, and I believe that the Chinese are still blocking Norwegian salmon so there, you know, retaliation. I don't know how signif--I don't think it's all that significant for the Norwegian economy, but it's also an example of China being willing to use trade for non-trade purposes.

HEARING CO-CHAIR CLEVELAND: Commissioner Wessel.

HEARING CO-CHAIR WESSEL: Mr. O'Connor, first of all, again thank you for coming.

I saw, I believe it was 7,000 Europeans protested on this matter last week so going to the issue of is this understandable to the public. I'd love to see what kind of pamphlets, et cetera, they were using so that we can understand how this is being communicated in terms of what the costs and benefits are. So, and I believe that was the second major public demonstration around this issue. That's number one.

But the question, and, Alan, I think you raised it, of how this may be dealt with, my understanding is Commerce could act on its own. It's an administrative matter so they could change the designation.

And going to Carolyn's point about the treatment of a Nobel Laureate, et cetera, I, you know, have concerns about what a future administration might do if there are other issues in the inbox. What would your thoughts be about giving Congress the right to approve any designation, not changing the methodology, which as I understand it is a WTO matter, meaning the methodology by which you determine this, but if you were to grant Congress the preapproval for any change in NME status, just as a procedural matter, that would be both WTO legal and it would provide a check in the process?

MR. PRICE: Yes. First, absolutely, it would be WTO legal. That's just a question of how you implement legislation and WTO requirements. Depending on the issue, certain changes that are required for WTO consistency already require acts of Congress so there is nothing particularly unique for that.

I think it would be a valid and appropriate option to consider right now. The designation of a country actually is not reviewed by domestic courts even.

HEARING CO-CHAIR WESSEL: Right.

MR. PRICE: So giving Congress a check in this I think would be, could be a very valuable assurance that we maintain what Bernard calls "an effective instrument."

HEARING CO-CHAIR WESSEL: And provide for a more public--

MR. PRICE: Right.

HEARING CO-CHAIR WESSEL: --debate and analysis rather than Commerce deciding one day that there is some other important factor, foreign policy or something else, that says let's go do this.

MR. PRICE: Yes. So I would say that Commerce or the President still has to administer the law, but, but certainly it would provide an important, important check on the process to assure that that is fully and properly adhered to, that it has been a concern, and we want to make sure that this is not--I think it's valid to say this should not be a political tradeoff. This should be a reasoned, legal and valid determination.

HEARING CO-CHAIR WESSEL: Thank you.

HEARING CO-CHAIR CLEVELAND: We've reached the--

VICE CHAIRMAN BARTHOLOMEW: I'm amazed we made it this far.

HEARING CO-CHAIR CLEVELAND: I was going to say, I mean I think probably--I was going to say given the opportunity, I think the Commission would keep you here for another hour, but notwithstanding the fact we've been going for eight. Is there anything else you all would like to say in conclusion before we wrap up?

Mr. O'Connor, you've come the farthest.

MR. O'CONNOR: I’d just add, the demonstration was--I'm glad to see it was 7,000 because--yeah, because--

HEARING CO-CHAIR WESSEL: You think it was over 100. Don't, don't say it was less than 7,000.

[Laughter.]

MR. O'CONNOR: Okay. Okay. But I'm very happy that that's the figure that has come out. It was very unusual in the fact that it had industry leaders and workers marching together, and I think that is probably the first time we've had it.

And also it was very interesting in the breadth of the support. The China MES issue has brought together a coalition which we call AEGIS, A-E-G-I-S, and that is made up of about 35 different industry sectors from the sorts of sectors you've been talking about here, steel, aluminum, but a whole series of others. And most importantly who has joined us is the heavy industries, power people, the Siemens, the ABBs of this world, who are the very companies who are driving a lot of exports to China and benefiting because, you know, the German machine tool industry has been supplying and has been very successful, and yet they have joined the coalition against market economy status.

So the next demonstration will be 10,000, but I think what's most important, I think, is the quality of the phone calls that are going through to our political leaders. That has changed dramatically in the last couple of weeks.

HEARING CO-CHAIR CLEVELAND: Interesting.

HEARING CO-CHAIR WESSEL: Thank you.

HEARING CO-CHAIR CLEVELAND: Thank you very much. We really appreciate your testimony, and we will take it on board and use it in our Annual Report. So we appreciate your appearance. Thank you very much.