

October 2010

**REVIEW OF CHINA'S COMPLIANCE
WITH ITS WTO COMMITMENTS**

**COMMENTS SUBMITTED TO THE
TRADE POLICY STAFF COMMITTEE
BY
THE NATIONAL ASSOCIATION OF MANUFACTURERS**

Key Areas of Concern in the 2010 Report:

- Currency misalignment
- Indigenous innovation policies and government procurement
- Rare earths policy
- Lack of intellectual property rights (IPR) protection
- Direct and indirect industry and export subsidies
- Deficiencies in standards and regulatory policies

Impact of China's WTO Accession on U.S. Manufacturers

The impact of China's WTO membership has been substantial—even dramatic—for many segments of U.S. industry. U.S. exports to China remained stable through most of 2009 and China remained the third largest foreign market for U.S. products after Canada and Mexico. However, bilateral trade continues to be highly imbalanced, with the U.S. deficit in 2009 totaling \$227 billion; and the manufactured goods deficit with China represents 75 percent of the total U.S. manufactured goods deficit. While a decline in imports helped to stabilize the U.S. trade deficit with China for a period during the financial and economic crisis, the deficit is rising again and there remains a need to increase Chinese purchases of U.S. goods to address the still-significant imbalance.

Many of the NAM's member companies see China as a major growth market, especially as near-term growth is expected to be slow in the industrial economies of the EU and the United States. Investments in China by U.S. firms are largely to serve the Chinese market with over 90 percent of U.S. investment in China for local consumption. This export and investment activity is not limited to large companies. Many small and medium-size U.S. manufacturers are also benefiting, with increasing numbers selling to or sourcing from China and some investing in production there.

While interest in the Chinese market remains strong, there are increased concerns about what many U.S. companies see as a rising protectionism and new initiatives that are designed to bestow advantage on domestic Chinese firms at the expense of foreign-invested firms or imported goods. The consolidation and growth of state-owned enterprises that benefited from Chinese stimulus funding during the global economic crisis is a cause for concern by many U.S. companies.

The NAM also hears from many import-competing U.S. manufacturers who believe that China's trade and financial policies, including its currency exchange rate policy and government subsidies, put them at an unfair disadvantage and caused a substantial loss of sales in the United States.

For U.S. manufacturers, trade with China continues to present a very mixed picture – potentially significant trade opportunities in a market that continues to grow rapidly; sustained competition from low-priced Chinese imports; and concerns about the long-term direction Chinese policymakers are headed with regard to openness to foreign investment and imports.

Key Areas of Continuing Concern

The NAM is encouraged by the high priority the Administration attaches to addressing China trade issues and the willingness of Chinese authorities to engage the U.S. government at senior levels. Ongoing bilateral engagement through the Strategic and Economic Dialogue (S&ED) for long-term strategic objectives and the Joint Commission on Commerce and Trade (JCCT) to address specific issues that arise in our trading relationship are essential to the maintenance of open and constructive dialogue between the United States and China. The NAM strongly supports the continuation of these important dialogues by the Administration.

In this 2010 report on China WTO compliance, the NAM is highlighting six areas of continuing concern: currency undervaluation; the rise of indigenous innovation policies and government procurement; restriction of rare earth exports; the lack of intellectual property protection; direct and indirect industrial and export subsidies; and deficiencies in standards and regulatory policies. Our selection of these issues does not mean that all of the other concerns noted in prior years' reports have been effectively addressed. Rather, the current list reflects both the magnitude of the impact that they are having on bilateral trade and the intensity of member interest in these issues.

Currency Misalignment

Persistent currency misalignment remains one of the most serious concerns of U.S. manufacturers facing Chinese import competition. But it is also an issue for U.S. exports into the Chinese market and in third markets. No other issue elicits as much, or as passionate, a response. In the view of many of our member companies, the undervalued yuan remains the single most significant distortion of global trade.

The misalignment is not a matter of market forces, but rather of government intervention in foreign exchange markets on a massive scale to maintain an undervalued currency. This has been widely acknowledged by global financial ministers, the IMF and both the Bush and Obama Administrations.

The NAM Board of Directors has passed a number of resolutions expressing concern over China's currency manipulation and the NAM has pressed the U.S. government for seven years on the importance of addressing this issue in all available venues both bilateral and multilateral.

While some may question the relationship of exchange rates to WTO compliance, and it is the Administration's decision whether or not to consider filing a case, the relevance of issue to the WTO is contained in the General Agreement on Tariffs and Trade (GATT) Article XV, now incorporated into the WTO. It states that members should not take exchange rate actions which "frustrate the intent of the provisions of this Agreement." The intent of the Agreement, in turn, as stated in broadest terms in the Preamble, is the objective of "entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade." Article XV clearly recognizes the relationship between exchange rates and trade and plainly envisions cases in which a member company could take exchange rate action which would "frustrate" the intention of the trade agreement.

Data from the United Nations on the impact that the yuan has had on China's competitiveness in manufacturing indicate why the GATT provision is so important. After devaluing its currency dramatically in 1994, China's share of world manufacturing output more than tripled from 4% to 13%. China's share of global manufacturing was relatively stable from 1981 and then began its dramatic rise in 1995, well before China's WTO accession in December 2001, commonly assumed to be the beginning of China's growth as a manufacturing powerhouse.

Indigenous Innovation Policies

The issue of China's implementation of an Indigenous Innovation policy is one that causes grave concerns among all NAM member companies. Recent directives have indicated a potentially serious rescission in China's openness to foreign investment and its commitment to the WTO principle of national treatment.

We applaud the Administration for making this issue a priority in bilateral engagement with China. In Tianjin recently, Premier Wen clearly said foreign investors' manufacturing locally qualified for procurement. This is a positive step, but problems remain as long as there is a policy in place that seeks to identify companies for procurement through catalogues or other lists that have the potential to discriminate in favor of domestic companies.

In addition, there is still a good deal of confusion and concern about the need for foreign firms to transfer their intellectual property in joint ventures in key industries identified as the focus of Indigenous Innovation policies. Directives outlining the policy seem clearly to support the forced transfer of foreign IP as well as the development of IP in China as a path in the development of Chinese national champions.

Government Procurement

China committed to join the Government Procurement Agreement (GPA) when it acceded to the WTO in December 2001. It took the first step by making its first submission at the end of 2007 and its most recent submission several months ago.

There remains the issue of inclusion of State-Owned Enterprises (SOE's) and provincial and local governmental entities. An agreement that does not cover state-owned enterprises (SOEs) or sub-federal procurement should be avoided. We support USTR's pressing China to improve its July 2010 offer. It has been ten years since China committed to join the GPA as soon as possible. The glacial pace of progress raises the question of possible Chinese violation of its articles of accession.

During this time, China has been taking actions under the Indigenous Innovation initiative (described above) that move in the opposite direction. It is not without cause that a number of NAM member companies question the seriousness of China's commitment to join the GPA. The NAM appreciates the difficulty of negotiating a comprehensive, effective agreement, but believes the United States and other WTO members must keep pressing, while also seeking a standstill in any new policies that reduce access to China's government procurement market.

Rare Earths

NAM member companies indicate that China's July 2010 announcement of further restrictions on exports of critical rare earth elements is going to have very serious repercussions for a broad range of industries. Companies were surprised at how quickly China implemented the new restrictions and are very concerned about the possibility of continued or further restrictions when the next announcement is made in January 2011.

The announcement in July occurred despite continuing U.S. government engagement and the work on a WTO dispute settlement case. There are reports that, at the current rate of development, Chinese industry would absorb most, if not all, of the supply of a number of elements that China produces by 2012. We cannot afford to wait until this happens before resolving this issue with China.

Serious price spikes in a number of key elements have occurred just in recent months for non-Chinese producers. With Chinese companies paying considerably less for the rare earth inputs, U.S. producers are concerned that they will begin seeing pricing from Chinese exporters that use rare earths in their production that U.S. companies cannot possibly match.

The NAM supported the recent passage of legislation in the House to support R&D and reopening U.S. mining of rare earths. But the necessary building of infrastructure will take time, with the earliest predictions being 2012-2013. However, even if the U.S. and Australian mines are reopened, U.S. companies say that this will not be enough for global markets and the issue of China's restriction of exports must be addressed.

Another hindrance to international exploration for rare earths is the history of China's mining in the 1980's and 90's. China's aggressive global pricing drove closure of much capacity outside of China. China's closure of some rare earth mining facilities could be reversed, thus potentially again driving down global prices to a point where the significant investment required to reopen mines would be lost or eroded. Potential investors in mining ventures are keenly aware of this, which may be suppressing capital investment to reopen non-China sources of rare earths.

China's actions in this instance are negatively affecting views of China's reliability and its commitment to the global system. China must remove its export restrictions on rare earths.

Lack of Intellectual Property Rights (IPR) Protection

NAM member companies report that the problems of IPR theft and enforcement remain rife in China. In spite of continued attention to this issue, most companies report that there has been little change in conditions over the past several years. Authorities at the provincial and municipal levels still are reluctant to take aggressive action to enforce IPR when it involves foreign companies. Companies must also devote significant resources to investigation and case development if they hope to have any action taken either administratively or within the judicial system.

The lack of IPR protection is an inefficient use of resources for large companies, but it is an insurmountable obstacle to small companies that have limited financial resources to protect their interests. In many cases, U.S. companies are experiencing damage to their reputation for quality and safety in third country markets.

The NAM is working with the Administration as part of the National Export Initiative (NEI) to expand export promotion services to small and medium-sized manufacturers. In looking at the Chinese import market, the fastest growing in the world, small companies often tell us that, while they believe that they could sell to China, they will not even try given the fear of intellectual property theft. As one NAM small company told us, "We hesitate to export our USA-made products to China for fear of violation of our IP rights."

A common complaint from U.S. companies is that IPR law in China still does not favor vigorous enforcement or punishment sufficient to act as deterrence. There are no effective administrative or legal directives that require criminal prosecution or destruction of the equipment used to make counterfeit products. Under current Chinese law, the value of a counterfeit item determines whether or not the Chinese manufacturer faces civil or criminal charges. Chinese law governing valuation of counterfeit goods that does not consider the market value almost invariably leads to less serious civil charges rather than criminal.

Another area of continuing concern is the potential for IPR violations during the non-transparent process of government information inquiries. This can range from formal inquiries as part of customs or approval processes to informal, drop-by meetings from local government officials who request sensitive company information. In formal inquiries, often the inspection/auditing process is so opaque that corrupt individuals within government agencies have little difficulty in stealing a company's intellectual property that is under review.

Direct and Indirect Industry and Export Subsidies

A positive development over the past year was the successful resolution of the U.S. dispute settlement case filed against China for 90 illegal export subsidies for "famous brands." The NAM strongly supported USTR in filing this case and USTR is to be applauded for working aggressively to settle this case with China, including verifying that the subsidies were removed before announcing the settlement.

Subsidies remain a very serious concern for many NAM member companies who would like to see follow-up by the Administration to ensure that there has been continued cessation of subsidies both from the WTO case and China's submission to the WTO.

The issue of subsidies is also pertinent to the area of investment. As capital controls are eased in China, successful Chinese companies are increasingly seeking to invest in foreign assets. Already, NAM member companies, especially in raw and basic materials, as well as the energy sector, have raised concerns about the possibility of competing in acquisitions with subsidized Chinese companies.

The NAM is a strong supporter of an open system of foreign investment both inward and outward. In order to avoid backlash against Chinese outward investment, it is important that Chinese investors not receive Chinese government subsidies that support bids not justified by sound economic and financial analysis, thus shutting out competition from companies not receiving government subsidies. This is especially important as the Administration moves forward with negotiations on a possible U.S.-China Bilateral Investment Treaty (BIT).

Unfortunately, because many of these subsidies are not export subsidies, this is one area in which existing disciplines in the WTO's Subsidies and Countervailing Measures (SCM) Agreement are not adequate to address practices which could become a major friction in our trading relationship. To the maximum extent possible, we encourage the Administration to use the JCCT and any other appropriate forums, including multilateral, to discuss the issue of actual and defacto subsidies that are distorting commercial flows and develop tools to address these practices.

Deficiencies in Standards Development and Regulatory Policies

As a WTO member, China has accepted important disciplines in the Technical Barriers to Trade Agreement (TBT) relating to the development of standards, technical regulations and conformity assessment procedures, with a view to preventing these from "creating unnecessary obstacles to international trade" (Art. 2.2). Technical trade barriers are important factors in determining not only the cost of market access in China but also the ability of manufacturers to market products based on U.S. technology and technical requirements.

Industry concerns about technical standards, conformity assessment practices and regulatory policies remain. China's practices still lack transparency and often unnecessarily raise the cost to U.S. manufacturers marketing their products. U.S. companies still find that there are problems with notice of regulatory or rules changes with comment opportunities.

China's commitments in the June 2008 Strategic Economic Dialogue (SED) to publish "all trade and economic-related administrative regulations and departmental rules" and "provide a public comment period of not less than 30 days from the date of publication" on the Chinese Government Legislative Information Website has produced some improvements, but the situation varies by ministry and province or city.

Another recurring problem is China's failure to allow foreign-owned conformity assessment bodies to be accredited. Regulators in the United States and many other countries accredit such foreign organizations based on clearly articulated criteria (e.g., international standards and guides) and generally do not discriminate based on country of incorporation. To the best of the NAM's knowledge, this has not yet happened, though foreign conformity assessment bodies were to have been eligible to operate in China by 2004. China's adherence to this commitment is vital, for in its absence, the costs and difficulties of complying with China's conformity assessment procedures will remain costly and difficult – certainly qualifying as a WTO-inconsistent trade barrier.

Conclusion

As one of the top trading nations in the world, and the second-largest economy in the world, China has benefited enormously from the open trading system that the WTO helps to sustain. Yet as the NAM report notes, problems with WTO compliance persist, and these compliance problems affect both U.S. manufacturers that sell their products in China and invest there, as well as those that compete with Chinese products in the United States and the global marketplace.

The United States should insist on full compliance and be prepared to enforce its rights when violations of WTO rules are not satisfactorily resolved. The NAM is fully supportive of U.S. trade agencies as they seek to address WTO compliance concerns and other trade issues affecting manufacturers. We appreciate the opportunity to submit comments to the Trade Policy Staff Committee for this annual review.

Submitted by:
Patricia Mears
Director, International Commercial Affairs
National Association of Manufacturers
(202) 637-3141