

## SECTION 2: ASSESSING AND ENFORCING CHINA'S COMPLIANCE WITH WORLD TRADE ORGANIZATION COMMITMENTS

### Key Findings

- China remains in violation of its WTO commitments in a number of important areas. While China has made progress toward meeting some commitments, shortfalls persist in many of the most significant areas for U.S. industries. As a result, U.S. firms continue to face market access barriers in China and unfair trade practices in U.S. and third-country markets.
- U.S. laws and the WTO provide remedies and safeguards for firms facing unfair trade practices and import surges from China. However, these trade tools to date remain underutilized and ineffective. Antidumping duties have gone uncollected; countervailing duties are presently inapplicable to China due to a Department of Commerce practice. The U.S. government has been slow to implement the China-specific textile safeguard and then the safeguard has been immobilized by litigation at a crucial time. Relief under the China product-specific (Section 421) safeguard has never been granted by the President despite three International Trade Commission decisions authorizing relief for the parties.<sup>80</sup>
- China has effectively marginalized the WTO's annual review of its progress in meeting its WTO accession commitments—the

Transitional Review Mechanism (TRM)—preventing use of the TRMs as a means of putting multilateral pressure on China to account for compliance shortcomings. In the future, it may be more productive to rely on the Trade Policy Review Mechanism (TPRM), applicable to all WTO members, to review China's WTO compliance. The TPRM will conduct its first review of China in April 2006.

- China's exchange rate practices, extensive system of government subsidies, and weak intellectual property protections and enforcement are key trade concerns negatively affecting a broad array of U.S. firms. Currently available WTO mechanisms have yet to be tested as solutions to address these vital trade concerns, despite their explicit design as remedies for trade disputes. It is important to note that the WTO does not cover internationally defined core labor standards.

### Overview

China negotiated and accepted a transitional agreement for its entry into the WTO due to the extensive economic reforms it needed to undertake to conform to the market practices of WTO members. The agreement required numerous changes in Chinese trade laws and government policies, which were to be phased in over the following years. The vast majority of the phase-in deadlines are now past.

Many of the major compliance problems persisted in 2004, even as China continued to address them with at least a nominal effort. China instituted a large number of reforms in 2002, but progress toward full compliance slowed in 2003 and 2004. Many of these persistent problems are of utmost importance to U.S. industries, but the United States has filed only one WTO dispute against China to date.

USTR's annual report on China's WTO compliance thoroughly catalogs China's shortfalls, and remains the official U.S. government assessment of China's compliance record. USTR's 2004 Report identified six areas of particular concern to the United States in which China's compliance remains deficient. These areas are intellectual property rights, trading rights and distribution services, services, agriculture, industrial policies, and transparency.<sup>81</sup> Independent assessments of China's WTO compliance, largely produced by industry groups, essentially concur with USTR's analysis.<sup>82</sup>

China remains in violation of many critical WTO commitments, having failed to make significant progress in the areas of non-compliance noted in the Commission's 2004 Report to Congress. China's continued recalcitrance is causing material injury to U.S. companies, workers, and communities. It also is contributing to a highly skewed bilateral economic relationship marked by a soaring U.S. trade deficit and a weakening competitive position for many U.S. firms.

China's participation in the WTO has ramifications for that institution, and for international economic and legal systems in general. The magnitude, dynamism, and developing nature of China's economy put it in a category apart from other WTO entrants, giving China the capacity to fundamentally alter the structure and envi-

ronment of international trade. China's inability or refusal to abide by many important WTO commitments, coupled with the scale of its economy, pose a challenge to the foundation of the international trading system.

### **Enforcing China's Compliance**

Despite incomplete compliance with WTO obligations, China has faced only one WTO dispute to date. As discussed in Section 1, the United States filed a dispute in March 2004 concerning China's discriminatory VAT on semiconductors that favored domestic producers. Japan, Taiwan, Mexico, and the European Union all joined the complaint after it had been filed. China quickly settled the dispute to the satisfaction of the petitioners before the case reached adjudication.

A number of China's practices in other areas are similarly ripe for WTO adjudication.

### ***Intellectual Property Rights***

As detailed in Section 1, violations of intellectual property rights (IPR) in China continue virtually unchecked. However, this is no longer primarily a function of lax IPR laws: China has improved many of its laws regarding IPR since its accession to the WTO. The major remaining legal loophole is a high monetary threshold that must be cleared before criminal charges apply. This threshold contradicts provisions of the WTO's TRIPS Agreement that calls for criminal treatment of IPR violations on a commercial scale irrespective of the value of the loss.<sup>83</sup>

China's principal IPR deficiency is effective enforcement of its laws, which is among its WTO commitments.<sup>84</sup> To date, with industry sources citing piracy rates above 90 percent, it is starkly apparent that China has failed to fulfill those commitments.<sup>85</sup> China pledged to enact a specific plan for protecting IPR during the April 2004 meeting of the U.S.-China Joint Commission on Commerce and Trade (JCCT). Subsequently, USTR conducted an out-of-cycle review of IPR protection in China and determined that China had not delivered on the promises made at the 2004 JCCT.

USTR maintains a watch list of countries with the most egregious failings in IPR protection. Those countries with the most egregious IPR violations that "are not engaged in good faith negotiations or making significant progress in negotiations to address these problems" are designated "Priority Foreign Countries" and face the possibility of U.S. sanctions.<sup>86</sup> Priority Foreign Countries can move to the less severe, transitional category of Section 306 monitoring if they enter into good faith negotiations or make significant progress in addressing cited problems. As a result of USTR's out-of-cycle review, China was demoted from Section 306 monitoring to the Priority Foreign Countries list.<sup>87</sup> This change in designation reflects the conclusion that China's participation in negotiations regarding IPR issues has not been in good faith, as evidenced by unabated IPR violations.

The July 2005 JCCT meeting resulted in more promises by China to take specific actions intended to reduce the theft of intellectual property. The Commission recognizes that these steps, if

completed, would improve the status of IPR in China, but reiterates that China repeatedly has made similar pledges to no effect.

China's failure to protect IPR is clearly within the jurisdiction of the WTO, given China's explicit obligations under the TRIPS agreement. Because China is not making satisfactory progress in this area, the United States should initiate action through the dispute resolution process at the WTO to address China's failure to comply with both the criminal penalties and enforcement provisions of TRIPS. In October 2005, USTR requested information from China regarding China's IPR enforcement efforts.<sup>88</sup> USTR's request exercises U.S. rights under the WTO's TRIPS agreement, but it will not automatically result in WTO consideration of action to require China to alter its approach to IPR protection. The U.S. can and should pursue further steps toward this end.

### ***Currency Manipulation***

As discussed in Section 1, notwithstanding its recent, modest revaluation, China's currency remains significantly undervalued through direct, intentional currency market intervention by the Chinese government. In joining the WTO, China consented to be bound by GATT Article XV, which states that "[c]ontracting parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement, nor, by trade action, the intent of the provisions of the Articles of Agreement of the International Monetary Fund." At a minimum, China's currency practices appear to frustrate the intent of GATT Articles VI and XVI that prohibit export subsidies. China's trade actions also violate IMF Article IV, which charges members to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." The Chinese government's continued intervention in the exchange rate market to support an under-valued renminbi exposes it to a WTO dispute.<sup>89</sup>

### ***Transitional Review Mechanism***

China's accession agreement provided for an annual review of its compliance with WTO obligations during its first ten years in the organization. WTO member countries negotiated for the Transitional Review Mechanism (TRM) to be a tool maintaining pressure on China to comply with its market-opening commitments. China agreed to this provision, but over its first three years of membership has effectively abandoned its commitment while claiming that it is discriminatory because it applies only to China. China has frustrated the intent of the TRM by refusing to answer questions in writing posed by trading partners during the TRM process and by preventing production of a meaningful TRM report. (The consensus-based nature of TRM reports allows it to block reports that it finds unsatisfactory.) As a result, the TRM has not become the consequential, multilateral forum for raising and resolving issues regarding China's noncompliance it was intended and expected to be. China's successful efforts to undermine this mechanism—which was key to U.S. support for China's WTO accession—remain of great concern to the Commission.

Notably, the WTO has begun its review of China under its standard trade policy review mechanism (TPRM), whereby all members are reviewed on a cyclical basis and a report is produced assessing the subject country's trade and economic policies. The review is scheduled for completion in April 2006 and will be repeated at two-year intervals thereafter. The TPRM may produce a more thorough analysis of China's market opening progress than the TRM process has produced to date. Unlike the China-specific TRM, the TPRM results in a report by the WTO secretariat that does not require consensus approval of the members. Even if the commencement of TPRM reviews allows the TRM to wither further into a largely worthless process, China's cooperation with the TRM will remain a useful metric, allowing insight into China's pattern of interaction with the United States and the WTO on trade matters and international obligations.

### **Trade Remedies and Safeguards**

Given significant and persistent trade concerns with China, it is critical that the U.S. government and U.S. firms make use of the tools available under U.S. law and the WTO to combat unfair trade practices and import surges. There are two China-specific safeguards available to provide U.S. firms with relief from near-term surges in Chinese imports: the product-specific safeguard and the textile safeguard. These were afforded to all WTO members on a temporary basis as part of China's accession agreement, recognizing the anticipated detrimental impact that rapidly increasing imports from China would have on the domestic industries of other member states. The product-specific safeguard will be available through 2013, and the textile safeguard through 2008.

In addition to safeguards, U.S. law provides for antidumping duties and countervailing duties to be assessed on Chinese goods when they are entering the U.S. market at prices below their fair value or benefiting from government subsidies. Countervailing duties (CVDs) are not currently applicable to China due to an administrative determination by the Department of Commerce. This Commission believes that determination should be reconsidered given that CVDs are designed to compensate for government subsidies to foreign producers—a hallmark of many Chinese exports. None of these trade tools has been used as effectively as possible against Chinese trade practices, nor even as effectively as anticipated during China's accession to the WTO.<sup>90</sup>

### ***Product-Specific Safeguard***

China agreed as part of its accession to the WTO to allow trading partners to use a product-specific safeguard in any case where a rapid increase of imports of a particular product from China is causing, or threatening to cause, market disruption to the domestic producers of that product. The United States implements this safeguard through the petition process codified by Section 421 of the Trade Act of 1974, allowing aggrieved U.S. companies to petition the International Trade Commission (ITC) when they believe imports from China have caused or will cause market disruption and material injury. If the ITC makes an affirmative determination, the President decides what relief, if any, will be provided.

To date, the ITC has rejected two Section 421 petitions and found that market disruption had occurred in four other cases. In each of the first three cases of affirmative finding by the ITC, the President rejected the ITC's recommended relief, exercising his statutory authority to waive relief in circumstances where the "provision of such relief is not in the national economic interest of the United States or, in extraordinary cases, that the taking of action . . . would cause serious harm to the national security of the United States." The President has yet to act on the most recent affirmative finding, which occurred on October 11, 2005. The Commission is troubled by this record; it believes that the intent of Congress in enacting the product-specific safeguard was that there would be a presumption of relief rather than the current predisposition against relief.

Industry representatives have told the Commission that they will be reluctant to initiate future safeguard actions against Chinese imports hurting their businesses, given the high legal costs of such an action, and the expectation that the President will deny relief even if the ITC recommends it. This effectively neuters the China safeguard and precludes it from offering the relief to American businesses that Congress intended.

### ***Textile Safeguard***

China's WTO accession agreement provides its trading partners through 2008 with a China-specific textile safeguard that allows them to place a temporary limit on increases in textile imports from China when a surge of imports is found to cause or threatens to cause a market disruption in designated product categories. This safeguard is implemented by the Committee on the Implementation of Textile Agreements (CITA), an interagency committee chaired by the Commerce Department. CITA accepts petitions and can also self-initiate use of the safeguard.

CITA first approved petitions for use of the safeguard in December 2003 and has continued to apply the safeguard with moderate frequency. The major exception to this pattern came in late 2004, when industry groups filed petitions covering 12 categories of textile imports from China.

The Multi-Fiber Arrangement (MFA) that governed global textile trade through a series of quotas expired by agreement at the end of 2004. As expected, U.S. imports of textiles from China swelled immediately after quotas were lifted, outpacing increases of textile imports from the rest of the world. In January 2005, imports of Chinese apparel products increased 546 percent.<sup>91</sup> In the closing months of 2004, when safeguard petitions based on the threat of market disruption were most relevant, U.S. retailers and importers filed suit with the Court of International Trade (CIT), claiming that CITA does not have the authority to consider threat-based petitions. The CIT granted an injunction against consideration of threat-based petitions, which was reversed in April 2005. The injunction prevented safeguards from being imposed during the period that post-MFA import surges from China first hit the U.S. market.

Despite the fact that the most important opportunity for their use has passed, threat-based petitions remain pertinent. When the

textile safeguard is applied, it limits further growth in imports of a particular product category from China to 7.5 percent for up to one year. Threat-based petitions allow domestic producers to seek reapplication of the safeguard to the category in question before a new influx of Chinese imports again disrupts the U.S. market.<sup>92</sup>

The textile safeguard was designed to provide a transition period for the U.S. textile and apparel industries to adjust to competition from Chinese imports. The safeguard is only available through 2008, but it has not been used with the urgency befitting the detrimental impact of Chinese textile imports on the U.S. industry. CITA did not initially promulgate procedures for filing safeguard petitions until 17 months after China joined the WTO. Then the injunction on use of threat-based petitions prevented the safeguard's use in mitigating the flood of Chinese imports that followed the end of the MFA. With only three years remaining before the safeguard expires, the United States must make aggressive use of this tool to provide the domestic textile and apparel industries with the opportunity to adjust to new competitive pressures.

#### ***Uncollected Anti-Dumping Duties***

The Department of Homeland Security's Bureau of Customs and Border Protection (hereafter, Customs) failed to collect \$260 million in antidumping and countervailing duties in 2004. Of that amount, \$224 million related to Chinese imports, with \$213 million pertaining to Chinese agricultural imports.<sup>93</sup> China was subject to 22 U.S. antidumping duties—more than any other country.<sup>94</sup>

Importers of some Chinese goods circumvent dumping duties by exploiting a loophole known as the "new shipper bonding privilege."<sup>95</sup> The importer of a product subject to an antidumping duty is ordinarily required to make a sufficient cash deposit to cover the estimated duty. Pursuant to a 1995 law, importers who receive such products from a new shipper are permitted to post a bond with Customs in lieu of the cash deposit. The bond or cash deposit is intended to function as a guarantee that Customs will be able to collect the requisite dumping duties. The exact duty owed is not determined until one to two years after the importation has occurred, and the importer is then either refunded or billed for any difference between the estimated duty and the exact duty. In the case of the uncollected duties, when the exact dumping duty has been determined, the party responsible for payment of the bond often is bankrupt or has disappeared, and no recourse is available.<sup>96</sup> The widespread problems in collecting imposed antidumping duties on Chinese imports undermine the effectiveness of this trade remedy in combating China's unfair trade practices.

#### ***WTO Rejection of CDSOA***

The Continued Dumping and Subsidies Offset Act of 2000 (CDSOA, also known as the Byrd Amendment for its author) transfers revenue collected through antidumping and countervailing duties to U.S. producers harmed by dumped imports. The WTO has ruled that the CDSOA violates U.S. obligations governing permissible responses to dumping and subsidies, and has authorized retaliatory measures by U.S. trading partners if the United States maintains the CDSOA.

The Commission believes that the WTO overstepped its authority in this decision, as the organization's rulings "cannot add to or diminish the rights and obligations" of WTO member countries.<sup>97</sup> Furthermore, the disbursement of funds to injured U.S. companies has become an important component of U.S. trade laws, providing needed relief to U.S. firms harmed by unfair trade practices of Chinese competitors and others. Having exhausted the WTO appeals process regarding CDSOA, the United States should act to clarify through future trade negotiations the right of WTO members to disburse revenue from antidumping duties to affected industries.

### ***Countervailing Duties***

U.S. law provides for countervailing duties to be assessed to counter the effects of foreign government subsidies that distort trade. However, U.S. producers cannot seek relief from Chinese subsidies through countervailing duty laws because the Department of Commerce, in a series of decisions finalized in 1986, opted not to allow the application of countervailing duties to nonmarket economies such as China. Commerce's practice was upheld by the U.S. Court of Appeals, but is not required by law.<sup>98</sup>

Commerce should reassess its decision not to apply countervailing duties to nonmarket economies. Its original decision rested on its interpretation that because a subsidy is a factor that distorts markets, it is impossible to identify a subsidy in a nonmarket economy. Since Commerce's decision, the 1994 WTO Agreement on Subsidies and Countervailing Measures provided a definition for subsidies that does not preclude their existence in nonmarket economies. Moreover, China's accession agreement explicitly recognized that subsidies exist in China.<sup>99</sup>

Without a statutory change authorizing the use of countervailing duties against nonmarket economies or a revised determination by Commerce, U.S. firms facing competition from subsidized Chinese companies will not be able to seek relief using the U.S. trade remedy designed for this purpose. Nonetheless, the United States can and should act against China's subsidies in the WTO.

### ***Market Economy Status***

China is currently and properly labeled a nonmarket economy by the United States, pursuant to stated criteria under U.S. law. The factors to be considered under U.S. law in granting market economy status include the extent to which the country's currency is convertible, the extent to which wage rates are freely determined by negotiations between labor and management, and the extent to which the government owns or controls the means and decisions of production.<sup>100</sup> It will likely be years before China can be labeled a market economy through a proper and forthright application of these criteria. Any premature change in China's market economy status would have a detrimental impact on the ability of the U.S. firms to seek antidumping relief against Chinese imports. Antidumping duties on nonmarket economies are calculated using prices in surrogate markets. It is generally believed that antidumping duties would be applied less frequently and at lower amounts if China were labeled a market economy.<sup>101</sup> Such a

change in designation should not occur until China fully and affirmatively meets the criteria in U.S. law.

Notably, Brazil has already expressed disappointment with the lack of Chinese investment following Brazil's designation of China as a market economy in November 2004. Subsequent imports from China have led Brazilian industries to seek the implementation of trade safeguards.<sup>102</sup>