

**THE EXTENT OF THE GOVERNMENT'S CONTROL OF CHINA'S
ECONOMY, AND IMPLICATIONS FOR THE UNITED STATES**

HEARING

BEFORE THE

U.S.-CHINA ECONOMIC AND SECURITY
REVIEW COMMISSION

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

—————
MAY 24-25, 2007
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Printed for use of the
United States-China Economic and Security Review Commission
Available via the World Wide Web: www.uscc.gov



UNITED STATES-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION
WASHINGTON : AUGUST 2007

U.S.-CHINA ECONOMIC AND SECURITY REVIEW

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U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

August 21, 2007

The Honorable ROBERT C. BYRD

President Pro Tempore of the Senate, Washington, D.C. 20510

The Honorable NANCY PELOSI

Speaker of the House of Representatives, Washington, D.C. 20515

DEAR SENATOR BYRD AND SPEAKER PELOSI:

We are pleased to transmit the record of our May 24-25 public hearing on “*The Extent of the Government’s Control of China’s Economy and Implications for the United States.*” The Floyd D. Spence National Defense Authorization Act (amended by Pub. L. No. 109-108, section 635(a)) provides the basis for this hearing, as it requires the Commission to submit an advisory report to the U.S. Congress on “the national security implications and impact of the bilateral trade and economic relationship between the United States and the People’s Republic of China.” In this hearing, the Commission reviewed the efforts by the government of China to maintain ownership or direct control of a large portion of its own economy while it seeks to use its large holdings of foreign exchange to gain ownership of private foreign assets.

The testimony at the two-day hearing focused on China’s intentions to create what it calls “national champion” firms in 12 industries over which Beijing has determined that it will maintain continued state ownership or control. These giant corporations, that China intends to equip to compete successfully on a global scale, will be fashioned from some of the estimated 167,000 companies that are currently state-owned. Today, many of the smaller companies in this group, particularly those affiliated with provincial or municipal governments, either are failing or are poorly run. A substantial number are unable to make payments on their bank loans. However, with a boost from a wide variety of government subsidies, including new infusions of cash from state-owned banks, the new consolidated companies, closely linked to the central government, will be equipped to compete effectively with U.S.-based companies in China, in the United States, and in many third-country markets.

Intensifying concern about this development is the fact that China is regressing in its record of meeting the commitments it made in order to secure membership in the World Trade Organization. China agreed to move its economy toward a more market-based system and away from state control.

Chinese Control of its Strategic and Heavyweight Industries

China has formally designated seven industries as “strategic,” and has announced that the state will maintain “absolute control [of these industries] through dominant state-owned enterprises.” These industries are armaments; power generation and distribution; oil and petrochemicals; telecommunications; coal; civil aviation; and shipping. It declared five industries to be “heavyweight” industries; the state will retain substantial

control of the companies operating in these industries. They are machinery; automobiles; information technology; construction; and iron, steel, and non-ferrous metals.

Mr. Barry Naughton, an economist at the University of California, San Diego, testified at the Commission's hearing that China's actions to retain government control of such a large portion of its economy are "definitely a step backwards" and "clearly violations of the spirit of the WTO." Many of the companies in these industries already are "large, powerful, and wealthy corporations that are a little bit government, a little bit market, and have mixed motives that affect how they operate in many different respects." More ominously, noted Naughton: "The Chinese government is now going to substantially step up the amount of money that it invests in research and development, the activity of the government in using procurement to foster a high-technology sector in China, and the flow of resources from the government to subsidize credit."

Other witnesses interpreted China's highly targeted industrial policy favoring certain industries as an attempt to rewrite the rules of the WTO. China is willing to subject its economy to market determinations only so long as that suits Chinese development goals, Clyde Prestowitz, President of the Economic Strategy Institute told the Commission. "The objective of the game is to be a leader in key industries, to be at the cutting edge of key technologies," he said. "If the market can get you there, great. However, if the market by itself can't get you there, then the players of this game will use other means . . . to get there."

Other witnesses warned that China's emphasis on retaining a strong state-owned and state-controlled industrial sector is part of an overall industrial policy that is spelled out in China's 11th Five Year Plan, which was officially approved in 2006 but which government authorities in Beijing are explaining and clarifying very slowly. Scott Kennedy, a University of Indiana political scientist, agreed with others who told the Commission that, in many ways, the industrial policy is at odds with China's WTO obligations. : "Although China's entry presaged a new era of economic openness, certain segments of China's government and industry, both state-owned and private, have over the last decade promoted protectionist industrial and trade policies rooted in exploiting loopholes in the WTO," Kennedy said.

Another economist, Dr. George Haley of New Haven University, warned that "contrary to U.S. policymakers' beliefs, China is not moving towards a Western-style capitalism-based economy." Rather, he said, the goal of Chinese policy-makers is to meld the government and the economy into an instrument of policy in order to preserve the status quo. "The Chinese government intends to carve out a lion's share of the world's economic power, political power, and prestige while maintaining the Chinese Communist Party's absolute control over China."

The government body that holds responsibility for linking the fate of the Party to the largest State-Owned Enterprises (SOEs) is the State-Owned Assets Supervision and Administration Commission of the State Council, known as SASAC. This organization directly runs the largest of the state-owned companies—originally 197 corporations but

now whittled down to a number estimated to be around 167. These are the largest and most widely known companies. They are also some of the most profitable, thanks to a variety of government handouts including forgiveness of debts to government owned banks.

SASAC maintains control of its corporate charges by appointing members, usually Chinese Communist Party (CCP) members, to the companies' boards of directors. SASAC also has the right to "screen, to appoint, to evaluate, to compensate and to dismiss SOE managers."

Some Government Aid to SOEs Violates WTO rules

China's extensive subsidies to business may violate the spirit and the intent of WTO membership and policies, but they do not necessarily violate the WTO's explicit rules on subsidies. Many nations, including the United States, employ subsidies to accomplish economic goals. Various trade remedies such as anti-dumping duties and countervailing duties are employed by nations to level the playing field under such circumstances. The WTO, while not participating in such remedies, explicitly allows their use

The use of subsidies that are contingent on exports, however, is considered an egregious practice. Such export-contingent subsidies are expressly prohibited by the WTO, and for good reason. Subsidies granted to companies that are intended to boost exports or to discourage imports are considered the most trade-distorting subsidies. They interfere far more with the international trading system than, for example, subsidies to one company designed to persuade it to locate in one jurisdiction instead of another. Export contingent subsidies can artificially lower the cost of production, granting an unfair advantage to an exporting company or industry and are prohibited by WTO rules for that reason.

China employs such export dependent subsidies. Many of China's largest SOEs receive such aid and "represent a potential problem for U.S. industries and international trade," according to Thomas R. Howell, a trade attorney with Dewey Ballantine LLP in Washington. He predicted a "rocky road" for relations between China and the United States until the controversy over subsidies to SOEs is worked out.

The United States has brought a formal complaint to the WTO alleging that China employs export-contingent subsidies. That case has not yet been heard by a dispute resolution panel.

China's Sovereign Wealth Fund and Its Potential Effects on the United States

Over the past decade, China has become an immense magnet for foreign direct investment, but has reciprocated hardly at all. As of the end of 2005, China's total stock of outward investment was just \$30 billion. The following year, 2006, the pace picked up as Chinese firms added \$16 billion in investments abroad. Nonetheless, the contrast is

stark: China receives as much foreign direct investment (FDI) in one year as its total accumulated outward investment.¹

This imbalance is expected to change, however. China has amassed \$1.3 billion in foreign exchange reserves, the largest cache of forex in the world. Much of this money—an estimated 70 percent—is invested in dollar-denominated bonds, principally U.S. Treasury securities that pay relatively low interest rates.² To seek a higher return and to diversify its holdings, China is creating a sovereign wealth fund. Even before this investment arm has been given a formal name, it has made its first buy—\$3 billion in the initial public offering of Blackstone Group, a U.S. private equity firm.

More such investments are likely. China already has said it would issue bonds—to be covered by its foreign exchange reserves—for \$200 billion of new investments. But this addresses only a small portion of China's growing reserves; it is now accumulating foreign reserves at the rate of \$400 billion a year, according to Dr. Brad Setser, senior economist at Roubini Economics.

This massive currency reserve increasingly is raising concerns in the United States and in other global financial centers. Were China to invest heavily in the United States, it would be the only non-NATO member nation or non U.S. ally investing at this level in the United States, noted David Marchick, an attorney with Covington & Burling. Marchick told the Commission that some might question whether China, through its investments, is seeking to obtain access to military or dual-use technology without having to contend with export controls and other impediments. He noted concerns that employees of Chinese-owned companies in the U.S. might be targets of China's intelligence services gathering valuable technical information.

Government, Not the Free Market, Rules International Steel Trade

According to testimony before the Commission, China's steel policy shows how state ownership and control combined with extensive government subsidies can threaten a U.S. industry—in this case, one that is vital to both civilian and military manufacturing. Beijing has adopted an explicit industrial policy to support steel production using a wide variety of subsidies. The result has been a dramatic increase in steel output in China resulting in production that far exceeds even China's skyrocketing domestic steel consumption.

In just four years, China transformed itself from a large steel importer to a large steel exporter by adding capacity at a record rate. In 2002, imports of iron and steel in China exceeded exports by 400 percent; by 2006, exports of iron and steel from China exceeded imports by 200 percent.³ As a result, China now produces 35 percent of the

¹ U.S. China Economic & Security Review Commission, testimony of David Marchick, attorney at Covington and Burling, May 24, 2007.

² U.S. China Economic & Security Review Commission, testimony of Dr. Brad Setser, senior economist, Roubini Economics, May 24, 2007.

³ Trevor Hauser and Daniel Rosen, the Peterson Institute for International Economics and the Center for Strategic and International Studies, seminar on The China Balance Sheet, May 2, 2007

world's steel. According to the American Iron and Steel Institute, "Chinese crude steel production more than quadrupled in the last ten years, growing from an estimated 100 million metric tons in [1996] to approximately 420 million metric tons in 2006... the rough equivalent of building three entire American steel industries in one decade."⁴

Steel industries in more market-oriented nations, such as the United States, face great difficulties in competing against such state-directed capacity expansions. The U.S. industry has been forced to undertake large-scale layoffs and consolidation in order to remain viable, despite enjoying high productivity rates.

The global glut of steel is perhaps the most dramatic example of the pitfalls of government investment in industries that government deems strategic. The potential for repeating this in other industries exists whenever government is too heavily invested in an industry. That potential certainly exists in China in the 12 industries deemed "strategic" or "heavyweight."

Recommendations

- The Commission recommends that Congress urge the Administration to employ all necessary trade remedies authorized by the WTO rules in order to protect vulnerable portions of the U.S. economy from the unfair advantages afforded to some Chinese firms by the government's extensive subsidy regimes. These tools include anti-dumping and countervailing duty penalties as well as temporary escape clause relief.
- The Commission recommends that Congress urge the Administration to press the Chinese government to abandon its intentions to preserve a huge, state-owned corporate sector and, instead, to embrace the tenets of free market economics. The existence of a large state-owned sector of the Chinese economy is in the best interests of neither China nor its trading partners.
- The Commission recommends that Congress and the Administration pay particular attention to the activities of the state-owned sectors of China's economy. That scrutiny also should apply to China's state-directed investments from its foreign currency reserves. While foreign investment is welcome in the United States, monopoly control is not. Nor is it advisable to create government-run businesses able to use the power of government to exclude competition. China's actions should be examined in order to ensure compliance with rules governing international trade.

The transcript, witness statements, and supporting documents for this hearing can be found on the Commission's website at www.uscc.gov. We hope these will be helpful as the Congress continues its assessment of U.S.-China relations.

⁴ U.S.-China Economic and Security Review Commission, *Hearing on the Extent of the Government's Control of China's Economy, and the Implications for the United States*, testimony of Barry Solarz, May 25, 2007

Sincerely yours,



Carolyn Bartholomew
Chairman



Daniel Blumenthal
Vice Chairman

cc: Members of Congress and Congressional Staff

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