CHINESE SUBSIDIES AND US RESPONSES

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U.S.-China Economic and Security Review Commission

Hearing on
China's World Trade Organization Compliance: Industrial Subsidies and The Impact on US and World Markets

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Good afternoon and congratulations to the Commission for devoting attention to the important issue of Chinese subsidies. It is a great honor for me to be here.

My perspective is that of a subsidy hawk. I have spent the better part of my professional life working to utilize, and to improve, existing subsidy disciplines and remedial tools. The views expressed here reflect that experience and are personal ones, not attributable to any client or any other organization with which I am affiliated.

The Commission's staff has circulated questions in three broad categories, on the *impact* of China's subsidies, on their *WTO-consistency*, and on *recommendations* ("What actions could the U.S. government take to create stable and fair U.S.-China trade?"). I can best assist the Commission by focusing on the third topic. Other witnesses have important things to say on the effects of Chinese subsidies in various sectors and geographic markets, especially the U.S. market; and China's failure to provide WTO-mandated subsidy notifications, and to rescind particular agricultural and industrial subsidies in a timely fashion, has been documented in the annual transition/review process and elsewhere. For example, the U.S. forest products industry has documented extensive direct subsidies in China, including debt forgiveness, soft loans and tax incentives, as well as indirect aid (loan and equity subsidies) provided at the behest of the central government or a local government.

As for recommendations, how to foster "stable and fair U.S.-China trade" is a broad (and very tempting) question, but I will confine my comments here to actions responsive to the problem of Chinese subsidies. Among the many options worth considering and currently subject to debate, I will focus on three: (I) use of countervailing duty ("CVD") law with respect to subsidized imports from China; (II) use of WTO dispute settlement (or CVD law) to address China's currency regime as a prohibited or actionable subsidy; and (III) taking subsidies, and subsidy allegations, into account in Exon-Florio reviews of inbound investments.

To begin with the punch line: the first is something the U.S. government *should* do; the second is something it *might be able* to do; and the third is something it *should not* do.

I. Extending the CVD Law

I believe a CVD remedy should be available with respect to goods of any origin, including those from countries designated as non-market economies ("NMEs"), such as China.

The CVD remedy is an important interface mechanism between economies, is relatively non-controversial policy-wise, and -- in addition to improving the lot of domestic industries harmed by subsidized import competition – has the virtue of actually discouraging wasteful subsidization. There is no WTO obstacle to applying the CVD remedy to NME products, and indeed importing jurisdictions other than the United States either have done so or would do so in an appropriate case.

As the Commission ponders what it might wish to say or do regarding this policy option, there are three points I would suggest keeping in mind: (1) legislation may not be needed; (2) Commerce in its CVD practice has been needlessly making the problem more rather than less difficult; and (3) the methodological concerns, especially regarding benchmark selection and possible "double-counting," are not as serious as some of the recent public debate would lead one to believe.

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First, it is not clear that legislation is needed. The presumed legal impediment to CVD cases targeting NME products today is a 1986 court decision, *Georgetown Steel v. United States*, 801 F.2d 1308 (Fed. Cir. 1986). But there is some question whether *Georgetown Steel* is still good law – whether, in view of statutory changes, a CVD case could be filed against NME exports today. The CVD law interpreted in *Georgetown Steel* was after all repealed in 1994 through the Uruguay Round Agreements Act, and the surviving CVD law was substantially amended -- notably through the inclusion, for the first time, of a definition of the term "subsidy." This definition copies almost verbatim Article 1 of the WTO *Agreement on Subsidies and Countervailing Measures* ("ASCM"), and its basic elements are a financial contribution and conferral of a benefit. *See* 19 U.S.C. §1677(5). This definition is not confined to activities engaged in by governments holding power in market-oriented economies; on the contrary, WTO Members have made clear that a NME government can bestow a "subsidy" according to the ASCM definition. Evidence for this includes, for example, the detailed negotiation with China about its right, after accession, to benefit from the various special "developing country" rules in ASCM Article 27 – a negotiation that would have been unnecessary had China been considered incapable of carrying out the actions described in ASCM Article 1. Press reports regarding the new U.S. and EU requests for consultations with China regarding auto parts indicate that the complaints include a claim of subsidies contingent on the use of domestic over imported products. Such a claim would make no sense if China were incapable of carrying out actions that meet the basic ASCM Article 1 definition of a subsidy.

1994 amendments aside, the actual holding of *Georgetown Steel* was that Commerce was not *obligated* to accept CVD petitions targeting NME products. There is no court holding on whether Commerce is *permitted* to accept such petitions. At issue in *Georgetown Steel* was whether Commerce had acted lawfully in terminating, and refusing to conduct, CVD investigations on products imported from several Soviet-bloc countries. Commerce had reasoned that the CVD law invoked could not be applied because concepts like subsidization and resource misallocation were meaningless in the context of a centrally planned economy. The question on appeal was whether Commerce's interpretation was permissible. The Federal Circuit said yes, finding Commerce's determination to be neither contrary to law nor an abuse of discretion. The Federal Circuit also added some *dicta* indicating its view that Commerce *could not* have applied the CVD law to NME products – but it was addressing, here, a hypothetical question.

And even these *dicta* rested on the practical difficulties impeding CVD analysis in a NME environment. The Federal Circuit reasoned that Congress *must* have intended to exclude NMEs because of the difficulty of determining the amount of the unfair advantage bestowed by a foreign government on an investigated firm. *Georgetown Steel*, 801 F.2d at 1315-16. The key issue, for the Federal Circuit and for Commerce, was the inability to identify benchmarks in the distorted NME environment. *See id.*, 801 F.2d at 1317-18; *Czech Wire Rod*, 49 Fed. Reg. at 19,376 ("Subsidies in market economy systems are exceptional events. They can be discerned from the background provided by the market system. No such background exists in an NME…. In such a situation, we could not disaggregate government actions in such a way as to identify the exceptional action that is a subsidy."). The benchmarks regularly needed in CVD analysis include, for example, market-determined prices against which Commerce can compare the price charged for a government-provided input, and market-determined interest rates which Commerce can use to capture the "time value of money" element of large non-recurring subsidies. In a thoroughly distorted NME environment -- before the transition to market economy status has begun, or even early in that transition -- these market-determined comparison points may indeed be difficult to pinpoint. While some subsidies (*e.g.*, a per-unit export bounty) could be readily identified and measured, an overall assessment of a given enterprise's level of subsidization in such an environment would be speculative. *Georgetown Steel* can be read as holding that such practical difficulties can be so substantial as to override what is otherwise a clear statutory mandate to countervail bounties and grants. But in an economy that has for many years been in transition – *i.e.*, in the NMEs of today -- valid benchmarks may well be available. To ignore this and hide behind *Georgetown Steel* as a permanent shield against NME countervail cases is revisionism, an attempt to recast in theological terms what was essentially a pragmatic (and legally superfluous) discussion by the 1986 court.

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In any event, an interesting question of first impression would be presented if a U.S. industry filed a CVD petition against NME imports today, under today's CVD law. Commerce might accept the petition. And if Commerce decided it could not, the reviewing courts might disagree. I wonder, and I know others do as well, why we have not seen a test case.

Second, Commerce's practice has been moving away from, not toward, this result. Unfortunately, far from narrowing or reconsidering the "NME exemption," the agency has been expanding it. In particular, *Sulfanilic Acid from Hungary*, 67 Fed. Reg. 60,223 (final) (2002), carved a significant *additional* hole in the CVD law's protection by ruling that large non-recurring subsidies bestowed in a foreign country prior to its "graduation" from NME status are not countervailable even after graduation. I have previously published a critique of this decision, in the Summer 2004 issue of *Harvard International Review*, and have made a copy of that article available to the Commission's staff. Accordingly, I will only briefly recite the highlights here.

The subsidies in question, a cash grant and an assumption of environmental liabilities, were bestowed during the last six months before Hungary's January 1, 1998 "graduation date." Ordinarily, such subsidies are amortized over the average useful life of renewable assets in the industry involved, in this case 11 years. So, if these 1997 bestowals were treated as subsidies, they would have yielded an allocated benefit in the "period of investigation" for the CVD case (calendar 2000). But Commerce determined that it was under no obligation to include pre-graduation subsidies in its calculations and, in fact, was precluded from doing so. Commerce relied on *Georgetown Steel*, maintaining that the issue had already been resolved there.

Problems with this decision include: (1) *Georgetown Steel* did not reach, or dictate the answer to, the question presented in *Sulfanilic Acid*. The court did not lay out rules for what would happen if a NME country graduated to market economy status, and a later CVD case included subsidy allegations dating from the pre-graduation period. (2) The *Sulfanilic Acid* rule contradicts Commerce's practice in graduating countries from NME status – a practice which recognizes that the transition process is gradual and not abrupt. (3) Commerce's *per se* rule on pre-graduation subsidies is bad policy as it encourages the bestowal of large capital subsidies in transitional economies. Under it, large subsidies which are bestowed just prior to a country's graduation, and which should be subject to CVD offset for the next 10-15 years, can continue to have trade-distorting effects and yet face no offset at all.

Since amortizable subsidies typically account for a sizable portion of the CVD rates calculated for industrial products -- *Softwood Lumber*, based mainly on recurring subsidies, being the notable exception -- the question of "how far back" one can look for subsidies is likely to be critical in any future CVD cases involving NME products. Unlike the methodological issues mentioned below, I believe this issue should be addressed in any CVD extension legislation.

Third, the methodological concerns about "how" to extend the CVD law to reach NME products have been overblown. This is particularly true with respect to possible double-counting – that is, the concern that the special *antidumping* calculations Commerce uses in an NME case may already include a full offset for government subsidies, so that offsetting those subsidies separately through a CVD order would provide double relief. This risk is present only when parallel AD and CVD cases are pursued, and then only for certain kinds of domestic subsidies. (Export subsidy margins are automatically deducted from antidumping margins, regardless of whether the exporting country is an NME.) Even advocates concerned about double-counting acknowledge that debt relief, for example, is not picked up or offset through the NME antidumping methodology. And debt relief is one of the most numerically significant categories of domestic subsidies Commerce encounters in CVD cases. Commerce has ample authority and expertise to avoid double counting in those circumstances where the risk is present. I see no reason why legislation extending the CVD law to cover NME products needs to mention this issue.

On benchmarks, too, I see no need for new statutory language because Commerce already has the authority and expertise to handle this issue appropriately. One noteworthy "CVD extension" bill contains China-specific language authorizing Commerce to "use methodologies for identifying and measuring the subsidy benefit which take into account the possibility that prevailing terms and

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conditions in China may not always be available as appropriate benchmarks," and further advising Commerce to seek to "adjust" terms and conditions observed to be prevailing in China before "considering the use of terms and conditions prevailing outside China." H.R. 3283, section 3(a)(2). There is nothing particularly wrong with the approach envisioned here, but it seems to match what Commerce would already do under the existing statutory provisions on measuring subsidies. CVD extension legislation could safely skip over this topic.

II. Challenging China's Currency Regime as a Subsidy

Applying the CVD law to Chinese products does not, of course, resolve the separate question whether China's currency regime can successfully be challenged as a subsidy. Some recent commentaries and position papers have wrongly conflated these two issues. Whether the currency regime can be characterized as a subsidy -- in CVD cases or in a WTO dispute settlement case – depends on whether the required elements as set out in the ASCM are present.

The China Currency Coalition ("CCC") has briefed this issue in detail, both in section 301 petitions seeking resort to WTO dispute settlement and, most recently, in Skip Hartquist's testimony today. Some of the issues are clear, some less so. My scorecard, for what it may be worth, is as follows:

China is subject to the prohibition on export-contingent subsidies. Export-contingent subsidies are so strongly disfavored that WTO rules, beyond the basic "prohibition," require expedited action by an offending Member and (absent such action) provide for retaliation that is not limited to trade effects. During its WTO accession talks, China committed to "eliminate all export subsidies, within the meaning of Article 3.1(a) of the SCM Agreement, by the time of accession. To this end China would, by accession, cease to maintain all pre-existing export subsidy programmes and, upon accession, make no further payments or disbursements, nor forgo revenue, or confer any other benefit, under such programmes." Working Party Report, WT/ACC/CHN/49, at 33; *see also* Accession of The People's Republic of China, Decision of 10 November 2001, WT/L/432.

The "financial contribution" requirement is satisfied. When a Chinese exporter, having been paid in dollars, comes to the Central Bank to trade those dollars for *yuan*, that exchange would seem to qualify as a financial contribution under ASCM Article 1.1(a)(1)(iii) ("a government provides goods or services …, or purchases goods"). It should make no difference, at this stage of analysis, whether the exchange is characterized as the government selling *yuan* or buying dollars. To the extent that there is any question whether money can be characterized as a "good" for purposes of Article 1.1(a)(1)(iii), the exchange transaction would also seem to qualify as a "direct transfer of funds" under Article 1.1(a)(1)(i). The CCC has asserted that the government in this context is also providing a service – basically a currency hedging service – which would qualify as a financial contribution under Article 1.1(a)(1)(iii) as well.

Under this reading, all governments that participate in exchange transactions are providing financial contributions – either directly under Article 1.1(a)(1)(iii) or, if they rely on private banks to handle exchanges, via the "entrusts or directs" standard of Article 1.1(a)(1)(iv). To hold otherwise would require doing violence to the plain language of Article 1.1(a). The interesting question is whether these financial contributions confer a benefit.

Showing a "benefit" is challenging. The claim that the Chinese government financial contributions at issue here confer a benefit rests on a comparison to the "probable free-market value of the *yuan*," which some (but not all) economists regard as significantly undervalued – meaning that the government is giving out "too many *yuan*" in post-export exchange transactions.

Holding the exchange rate above 8 *yuan* to the U.S. dollar, if market fundamentals suggest something closer to 5, would certainly convey a "benefit" in the lay sense of the term. Among other effects, it would make Chinese products far more affordable in the United States – enabling Chinese producers to achieve much higher export volumes and revenues.

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But “benefit” in the ASCM has a technical meaning. If the financial contribution consists as suggested above in the government providing or purchasing goods (Article 1.1(a)(1)(iii)), then the likely standard for whether a benefit exists is whether the government is receiving less than (or providing more than) “adequate remuneration.” (This standard appears in ASCM Article 14, and so applies directly in CVD cases, but would also likely inform the benefit analysis in a case brought directly under the ASCM.) The first resort in checking the adequacy of remuneration is to look at what other sellers and buyers in the same jurisdiction are giving and getting in similar transactions. That inquiry sheds no light here, however, as there appears to be no separate private market in China for dollar-to-*yuan* exchanges at privately-negotiated rates. It is also possible, in certain circumstances, to look outside the jurisdiction for evidence of a market value (the “cross-border” issue litigated with so much fanfare in the *Softwood Lumber* case), but that doesn’t help here either since there appears to be no jurisdiction in which dollar-to-*yuan* exchanges are occurring at rates other than the rate set by the Chinese government.

So, to conclude that the remuneration is incorrect here would require resort to analytical techniques never before used in any case of which I am aware. The legal and psychological challenges are formidable. A WTO panel might be reluctant to hold that the one observable dollar-to-*yuan* exchange rate on earth is simply wrong – no matter how many economic studies can be marshaled in support of this view.

And there is also the question of what to make of the various indications that currency misalignment – or at least manipulation – is an area of shared WTO and IMF competence. Topping this list is GATT 1994 Article XV (“Exchange Arrangements”), and particularly Article XV:9(a) which states that “nothing in this Agreement shall preclude … the use by a contracting party of exchange controls or exchange restrictions in accordance with the Articles of Agreement of the {IMF} ….” Article XV seeks to promote coherence between WTO and IMF rules and actions. Like antitrust authorities in different jurisdictions, they should refrain from imposing mandates that are inconsistent (one requiring “X” and one prohibiting “X”), and to the extent possible, conduct examined and approved by one organization should not be condemned by the other. At minimum, Article XV would seem to require close consultation with the IMF in making any formal judgment (in a WTO dispute settlement case or otherwise) regarding misalignment of the *yuan*.

That said, Article XV:9(a) is not a solid shield. The fact that IMF-compatible currency arrangements are presumptively GATT-consistent does not mean that they are presumptively ASCM-consistent. The ASCM is a distinct WTO agreement, setting out numerous obligations additional to those in the GATT itself. (This relationship between the GATT and other closely related WTO agreements has been extensively addressed in the safeguards context.) Additionally, it seems possible that enforced undervaluation of a currency can result in a subsidy under the ASCM definition without necessarily qualifying as "currency manipulation" as defined in the IMF Articles of Agreement. For instance, as noted by the CCC, currency manipulation for IMF purposes includes an “intent” requirement not present in the ASCM.

Characterizing the financial contribution as the provision of a (currency hedging) service leads to a different and possibly easier “benefit” analysis. Such services normally cost money, sometimes quite a lot. Strict governmental control of the exchange rate – even if there is now a narrow band in place rather than a straight peg -- does appear to shield Chinese exporters from the expense of hedging against foreign-exchange losses or purchasing guarantees to guard against exchange-rate fluctuations. As far as I can tell, exporters pay nothing for this service. “Nothing” might well be characterized as “less than adequate remuneration.” Indeed, if the currency regime really does include this feature, it might even be considered a *per se* ASCM violation under item (j) of the *Illustrative List of Export Subsidies* (ASCM Annex 1), which identifies as an example of a prohibited export subsidy “{t}he provision by governments … of exchange risk programmes, at … rates which are inadequate to cover the long-term operating costs and losses of the programmes.” Although apparently not labeled as an exchange-risk program, China’s currency regime may function as one.

There are, admittedly, other ways to look at the “benefit” issue. Pending legislative proposals, for example, aimed at confirming the U.S. CVD law’s applicability to the Chinese currency regime, would amend current statutory provisions on “benefit” to provide that a benefit exists “in the case of

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exchange-rate manipulation …, if the price of exported goods is less than what the price of such goods would be absent the exchange-rate manipulation." *See, e.g.*, H.R. 5043, section 402 ("Clarification to Include Exchange-Rate Manipulation as Countervailable Subsidy Under Title VII of The Tariff Act of 1930"). This different conception of benefit appears to flow from a different characterization of the financial contribution.

If there is a subsidy, it is probably export-contingent. A subsidy (financial contribution plus benefit) is prohibited under ASCM Article 3 if it is export-contingent, either in law or in fact. This initially seems like a stretch in the case of a subsidy (assuming now that one exists) that is equally available to, and given to, *anyone* who has occasion to exchange dollars for *yuan*. But Chinese exporters might qualify as a discrete group of beneficiaries who can *only* get the subsidy by exporting. As in the *United States – FSC/ETI* case, this may be enough to support a finding of export-contingency. The subsidy to these beneficiaries is literally dependent upon the existence of exports; they cannot enjoy or receive it without exporting. Thus, the subsidy can be considered as either expressly (legally) contingent on exporting, or at least as "in fact tied to actual or anticipated exportation or export earnings." See ASCM Article 3.1(a), n.4.

It would of course be useful here to know what the amounts are – what share of dollar-to-*yuan* conversions in a given year is accounted for by exporters who have been paid in dollars, and what share by everyone else (tourists, investors and such). This is another area in which greater transparency on China's part might help to elucidate – conceivably with favorable implications for China – how the exchange regime functions and what its effects are.

If the currency regime confers a subsidy, and if that subsidy is export-contingent, then the specificity requirement is deemed to be satisfied under ASCM Article 2.3. If there is a subsidy but that subsidy is not export-contingent (*i.e.*, if it is a domestic subsidy), then to be actionable it must be shown to be specific according to the criteria in ASCM Article 2.1, and to cause adverse effects according to the criteria in ASCM Articles 5-6.

An actual WTO dispute on this point is unlikely. My informal survey of trade wonks, WTO experts, and China hands suggests that an ASCM complaint against China's currency regime would be, as the *Japan -- Film* case proved to be a decade ago, a "bridge too far" for the WTO. At present it seems to be a bridge too far for the U.S. government. It is worth noting, however, that the *Japan -- Film* case had some salutary results which both preceded and followed the disappointing WTO panel decision. Japan modified or repealed some measures along the way, taking them "off the table" as far as the dispute settlement case was concerned. And Japan also made numerous commitments before the WTO panel regarding how it would apply measures that remained on the books. These commitments played a role in the panel's decision to side with Japan. They also influenced Japan's later behavior, particularly when the U.S. government made clear its intention to monitor Japan's compliance with them over time. Market access did improve. It didn't look like a "win," but in many respects it was. Maybe there is a lesson here.

III. Considering Subsidies in Investment Review

A final category of potential responses involves taking subsidies (or subsidy allegations) into account in the Exon-Florio investment screening process.

"Investment subsidies" present a tricky issue. Foreign direct investment ("FDI") is generally good for the United States; we need lots of it given our public and private (dis)saving rate. I suspect that if one were to look across the last 50 years of incoming FDI, and then mentally subtract all those investments made by entities that had received government subsidies, the total would shrink substantially. Would we be better off in that hypothetical scenario? I doubt it. In principle, FDI by subsidy recipients seems to be just as beneficial as any other type of FDI.

How to square this view with a general support for strict subsidy disciplines? Subsidies are, in general, wasteful and misguided. But there is a reason for having different rules for goods trade

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and for investment – why we have never had a rule disfavoring incoming investment by subsidy recipients. When foreign subsidies result in low-priced imports, there are both winners and losers on the U.S. side: winners who get cheaper goods, losers forced to try to compete at the subsidized price level. But when foreign subsidies result in U.S. assets being bought for a higher price than they would otherwise attract, it seems to me there are normally only winners, no losers, on the U.S. side, and thus no basis for any public policy response related specifically to the subsidies.

Foreign government *ownership* of an investor is a different matter. Government ownership and subsidies often go hand-in-hand, but not always. Government ownership is more clearly connected to the national security focus of an Exon-Florio review. The national security arguments in an Exon-Florio case – including one where the foreign investor is Chinese -- are what they are. I don't think those arguments derive any added force from the presence (or alleged presence) of subsidies. ("Alleged presence" being more appropriate because even a minimally rigorous subsidy analysis would be impossible in the tight time-frame applicable to CFIUS reviews.)

IV. Effectiveness of WTO Subsidy Disciplines

While the U.S.-China trade relationship does not lack for bilateral issues, China's WTO membership is pulling an increasing share of issues into the WTO forum; particularly where subsidies are concerned, WTO rules will largely determine the form and substance of any U.S. response in the future. Accordingly, anyone concerned about Chinese subsidies and their effects on U.S. economic interests must necessarily be concerned about the effectiveness of WTO subsidy disciplines.

Unfortunately, there are reasons to be worried here. ASCM reform proposals tabled so far in the Doha Development Agenda negotiations have overwhelmingly favored weakening existing multilateral disciplines and the CVD anti-subsidy remedy. Members have tabled proposals aimed at narrowing the range of prohibited subsidies, at "green lighting" broad categories of aid, at loosening the already-loose constraints on export credit agency operations, at making it harder to demonstrate "specificity" in subsidy cases, at making it harder to act against "upstream" subsidies, and at eviscerating the CVD remedy which to date has been one of the few effective deterrents to trade-distorting industrial subsidies. Not all of these proposals are sure to win approval, and there is some pressure in the opposite direction; the U.S. government, for example, did recently table a useful proposal relating to prohibited subsidies and subsidy notification requirements. TN/RL/GEN/94 (Jan. 16, 2006). But the weight of proposals in this area seems to reflect a collective recoil from the disciplines agreed in the Uruguay Round rather than a determination to see those disciplines solidified or extended. (For details, see "WTO Subsidy Discipline: Is This the 'Retrenchment Round?'" in Volume 38(6) of the *Journal of World Trade* (December 2004).)

Any weakening of the WTO rules will narrow the already-limited range of options available to the U.S. government when seeking to respond, in the future, to dislocations caused by Chinese industrial subsidies.

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It has been a great honor to appear before the Commission, and I look forward to your questions.