

Andrew Szamosszegi
Capital Trade Incorporated

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

Hearing on China's Industrial policy and its
Impact on U.S. Companies, Workers, and the
American Economy

March 24, 2009

Good afternoon. My name is Andrew Szamosszegi. I am a managing consultant with Capital Trade Incorporated. I am honored to testify before the Commission on China's industrial policy and its impact on U.S. companies, workers, and the American economy.

I have recently co-authored an analysis of subsidies provided by the government of China to domestic and foreign firms in the so-called absolute control and heavyweight industries. Telecommunications is one of China's absolute control industries and is therefore considered of vital importance to the proper function of China's safety and economic well being. Information technology is considered one of China's heavyweight industries, and is also considered to be of special importance. My report therefore contains information relevant to today's hearing, and my testimony will rely heavily on information collected while preparing that study.

The Capital Trade subsidies report reviewed the financial statements of three firms relevant to today's inquiry: China Telecom Corporation Limited, China Electronics Corporation Holdings Company Limited, and IRICO Group Electronics Company Limited. Information about equipment providers Huawei and ZTE was also reviewed, and I will reference that as well. With the exception of Huawei, these quasi-public companies have SOEs with similar names. To avoid confusion, the firms I refer to as China Telecom, China Electronics, and IRICO are subsidiaries, not the 100 percent state-owned parents.

Point 1: The government is a major player in the telecom and IT sectors.

Our study suggests that the government plays a significant role in the telecom and IT industries. I just want to highlight the government's role in three areas: ownership, subsidies, and policy guidance.

In terms of ownership, the government remains a major player in this space. As of December 31, 2007, state-owned enterprises and other government entities owned approximately 83 percent of China Telecom, 75 percent of China Electronics, 75 percent of IRICO, and 18 percent of ZTE.

Government ownership in China means something. Typically, state-ownership confers access to loans from Chinese state-owned banks, below-market financing from those banks and related companies, and access to government grants. In the case of telecom, the government has already announced that state and state-owned financial institutions will support the development, deployment, and export of domestically developed telecom technologies. The extensive ownership by the Chinese government suggests that the government will have many levers at its disposal to make firms in this space toe the line with the government's industrial policy. Under these circumstances, we should not be surprised if firms stress goals other than profit maximization.

Point 2: The government provides these sectors with meaningful financial support.

The firms we examined all received significant government aid. China Telecom is a case in point. By the end of 2007, it had 220 million fixed line subscribers and 35 million broadband subscribers, and described itself as China and the world's largest wire line

telecommunications and broadband services provider. Despite this firm's preeminence in the Chinese market, it was still a major recipient of state support. In 2007, it benefitted from large tax breaks for investing in western China and for its purchases of domestic equipment. The firm also purchased subsidiaries in Hong Kong and the Americas from its government-owned parent at below market prices. In all, the government subsidy to China Telecom indicated in its annual report was nearly \$700 million in 2007.

ZTE's annual report shows it too receives subsidies. It benefits from a number of special tax preferences, such as the two full, three half program, special VAT rebates related to software procurement and high tech production, and an R&D grant. These preferences amounted to \$162 million in 2007.

China Electronics and IRICO are much smaller firms and they received subsidies of \$4 million and \$46 million respectively. What is interesting about these firms is the extent to which the government has played a role in their recent restructurings in the face of unfavorable trends. In the case of China Electronics, its state-owned parent performed a nifty reverse listing in Hong Kong by purchasing newly issued shares from an existing company on the Hong Kong Stock Exchange and effectively becoming the firms' majority owner. The firm's existing business lines were sold, leaving only the handset operations of China Electronics, a major producer of Philips branded phones. Philips has since exited the mobile handset business, leaving the brand and sales channel to China Electronics. IRICO experienced a similar misfortune as the world has moved to flat screen TVs, thereby reducing demand for IRICO's primary product, color picture tubes. The government's response was telling. IRICO's state-owned parent company built China's first LCD-TFT glass substrate production facility and then sold it to IRICO at a discount. IRICO is also the beneficiary of preferential tax rates, government grants, and preferential loans.

The subsidies received by these firms are not trivial. The value of the subsidies calculated from the China Telecom's 2007 annual report is more than half of the value of money raised by the firm in 2002 from its initial public offerings in Honk Kong and New York. For ZTE, the estimated subsidy calculated from the 2007 annual report amounts to 36 percent of the funds it raised in its 2004 public offering in Hong Kong. For IRICO, the 2007 subsidy is equivalent to 46 percent of its 2004 public offering in Hong Kong.

Point 3: China's industrial policy toward telecom services is multifaceted and extends beyond competitiveness.

The Chinese government seems to be pursuing a number of different goals. One, it wants to improve telecom service in the domestic market. Two, it wants to encourage activity in the western part of the country. Three, the government is also looking to consolidate the telecom services sector. I am not only speaking of the current tie ups pushed by the government. It is reasonable to conclude that the cash haul from the China Telecom's 2002 IPO funded the firms' domestic buying spree thereafter. Four, the government is pushing the adoption of homegrown technology and the use of domestic equipment, and is deploying the resources of state-owned financial institutions to achieve these ends. This goal seems to be above all others. For all intents and purposes, the government is

forcing the TD-SCDMA technology onto China Mobile and telling the main domestic service providers that they will be judged by their ability to develop and propagate homegrown technologies. While it is true that the government also has dreams of competition in international services, it is possible that pursuit of these other policy goals has the potential to get in the way.

Point 4: The impact of China's support for the telecom and IT sectors has both short and long-run dimensions.

The Capital Trade study includes policy simulations that assess the potential effects of reducing Chinese subsidies to absolute control and heavyweight industries on the Chinese and U.S. economies. Without getting into specific numbers, I will say the subsidies are harmful to U.S. interests in the short run. Were these subsidies removed, U.S. employment, exports, domestic sales, and economic welfare would rise in the targeted sectors, while China would experience lower exports and higher imports in these sectors.

The long run dimensions of this subsidy problem are even more troubling. U.S. data indicate that the stock of equipment in the U.S. manufacturing sector has been stagnant since the year 2000. This is no surprise in light of the massive increases in manufactured imports from China. Data also indicate that capital expenditures by the majority-owned manufacturing affiliates of U.S. multinational corporations in China have been increasing during this period, and that manufactured imports from China have been increasing as well. Combined, these two trends suggest that foreign investment in China may be replacing capital investment in the United States. To assess the potential effects of such a trend on U.S. economic performance, we ran a long-run policy simulation in which capital stock was shifted to the U.S. from China in conjunction with a removal of subsidies in China. The result was an even more significant improvement in the performance of U.S. industries at home and abroad, and a larger increase in U.S. economic welfare.

Point 5: Any remedies to subsidies in this space may have to go through the WTO.

Given the widespread use of subsidies by China, and their adverse impacts on U.S. producers, it is curious that more U.S. industries are not utilizing U.S. trade laws. Part of the answer to this puzzle may lie in the high levels of U.S. foreign direct investment in China. Because the government in China has a much larger economic footprint in China, U.S. firms with operations there may be reluctant to file CVD petitions against Beijing. Unlike antidumping cases, subsidies cases require participation from the government of China. If you are a U.S. firm operating in a special economic zone and benefitting from Beijing's generosity, it might be very difficult for you to file a petition that, in essence, puts the government of China on trial for programs that are similar to the ones putting money in your pocket. If we look at the firms filing petitions, they tend to belong to U.S. industries such as steel and paper, with limited participation in China, or from smaller, largely domestic, industries. Beijing has no leverage over them, so it is easier to file a petition if the subsidies are hurting your U.S. operations. Another factor limiting the use of domestic trade remedies is that the Chinese market is booming and a potential source of huge profits in the future. If you are a player in that market, and many IT and telecom

equipment vendors are because China traditionally had few domestic sources for these products, then you do not want to get on “Red Star’s” bad side.

Given these circumstances, the WTO may be the best venue for addressing Chinese subsidies. The United States usually has to take the first step, as was the case in the prior subsidies cases and in the current case against China’s “famous brands” program. But once a case has been filed, other countries have participated in the process. Because the U.S. industry is not a direct participant in WTO investigations and the U.S. government has the visible support of other countries, a WTO filing is less likely to cause “blowback” than a CVD petition filed by U.S. producers.

It is doubtful that the WTO can solve all of our problems regarding any adverse U.S. impacts of China’s state support. However, the United States has had some success with the WTO. For example, China agreed to delay implementation of its plan to increase tariffs on imported parts that were contingent on the localization level of Chinese produced vehicles. Unfortunately, China appears to have made this concession only after extracting promises from several foreign carmakers to increase local content. The last dispute settlement action against certain subsidies programs also resulted in China promising to end a variety of programs, including certain tax provisions that favored foreign investors. Many firms that are now paying corporate tax rates of 15 percent or less will see rates rise to 25 percent in stages over the next several years.

Point 6: On the telecom equipment side, the challenge has less to do with standards and more to do with manufacturing prowess.

Huawei is a major force internationally. Its revenues have increased at a compound growth rate of 33 percent from 2001 to 2007. According to an Economist Intelligence Unit report, the firm is ranked number 1 in the world in terms of commercial WiMax contracts and its shipments of 3G and 2G mobile phone networking equipment doubled during the first half of 2008. Growth has been strong internationally. In 2007, 72 percent of its growth came from increased penetration of international markets, with a growth rate of 150 percent in developed markets. Huawei has also been very successful in Latin America.

In terms of its technological prowess, Huawei’s R&D labor force is 35,000 strong and it spends 10 percent of revenues on R&D. It is one of the top applicants for UMTS 3G essential patents and among the worlds’ top 3 holders of LTE essential patents. It had filed 35,773 patent applications by December 2008.

ZTE is smaller than Huawei overall, but is no slouch. ZTE’s revenues increased 24 percent annually from 2001 to 2007, and its exports are expected to expand 30 percent in 2009 despite the weak global economy. The company actually has a higher market share in China than Huawei. ZTE also strives to spend 10 percent of its revenues on R&D. It has applied for 17,000 patents, including 1,000 3G terminal patents.

The two firms’ combined growth is impressive. They have gone from a \$3.4 billion in revenues in 2001 to \$17.1 billion in 2007. Their annual revenue growth during the period

has been 31 percent. According to the Census Bureau's MA334P, the U.S. trend is heading in the opposite direction. The U.S. growth rate from 2001 to 2007 was negative six percent, compared to positive 31 percent for Huawei and ZTE. The value of telecom equipment shipments by U.S. producers was \$61.9 billion in 2007, less than four times the revenues of Huawei and ZTE combined.

When I consider the rapid progress made by these two firms relative to U.S. firms, the U.S. consumer electronics industry comes to mind. Back when countries were racing to develop HDTV, someone, it may have been Peter Drucker, said that it did not matter who invented it, because Japan had raced so far ahead of the United States in manufacturing that whatever standard was adopted, Japanese companies would be able to make it. This was prophetic. Japan's NHK developed and, in 1987, began broadcasting over analog HDTV. Digital HDTV, what we are all watching now, was invented in California in 1990 by a Korean-born engineer working for a firm called General Instruments. But today, when I look around the competitive landscape, I see many Americans buying digital HDTVs, but no U.S. firms producing them in large quantities. The one I know of, a niche player called Olevia, entered chapter 11 last year.

I do think standards are important, and I do worry about the implications to U.S. economic security of China's rapid ascent up the ladder of technological innovation. I am also perturbed that the government of a country that already has a massive trade surplus with the United States is spending billions of dollars so that it can replace high tech imports with domestic products, and likely to tilt the playing field in China against U.S. producers. But what worries me more than standards are the negative trends on the production side of things -- that we are repeating the mistake of letting a country get so far ahead of us in manufacturing this important set of products that standards ultimately will not matter.

Filename: Szamosszegi_Testimony_032409 (2)
Directory: C:\Documents and Settings\Jertman\Local
Settings\Temporary Internet Files\OLK5E
Template: C:\Documents and Settings\Jertman\Application
Data\Microsoft\Templates\Normal.dot
Title: Testimony before the U
Subject:
Author: authorized user
Keywords:
Comments:
Creation Date: 3/23/2009 4:04:00 PM
Change Number: 4
Last Saved On: 3/24/2009 5:43:00 PM
Last Saved By: nsalidjanova
Total Editing Time: 7 Minutes
Last Printed On: 3/26/2009 2:12:00 PM
As of Last Complete Printing
Number of Pages: 6
Number of Words: 2,518 (approx.)
Number of Characters: 13,097 (approx.)