

Testimony of the Honorable Dennis C. Shea
Chairman, U.S.-China Economic and Security Review Commission
before the U.S. Senate Committee on Banking, Housing, and Urban Affairs
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Thank you, Mr. Chairman, Ranking Member Brown, and Members of the Committee, for the opportunity to testify today. Before we begin, I would like to note that this testimony reflects my personal views and not necessarily the judgments of the U.S.-China Economic and Security Review Commission. That said, my views are informed by my nine years of service as a Commissioner, and I commend to you the Commission’s analysis of the U.S.-China relationship and the challenges and opportunities it presents.

When China acceded to the WTO in 2001, there was great optimism surrounding the future of U.S.-China relations. Supporters of China’s entry into the WTO claimed that not only would the U.S. economy benefit from increased exports to China, but China’s accession would also enhance U.S. national security, lead to greater liberalization of China’s authoritarian political system led by the Chinese Communist Party (CCP), and transform China’s state-dominated economy into one driven largely by market forces.

Unfortunately, these high expectations have not been realized. The government continues to dominate many aspects of China’s society and economy, and many important businesses remain state-owned or state-controlled. At face value, recent reform initiatives, including those highlighted in the Third Plenum and the 13th Five-Year Plan, promote restructuring and efficiency, but their ultimate aim is strengthening government’s role in the economy with the purpose of preserving the primacy of the CCP. This presents a particular challenge for the United States, whose companies are directly affected by China’s actions.

The rest of my testimony will be spent discussing some of these issues in greater detail.

STATE CONTROL OF THE ECONOMY

The Chinese government props up its state-owned enterprises (SOEs) and designated private firms while limiting market access for U.S. and other foreign firms through strict market entry criteria, opaque regulations, compulsory joint ventures, and China-specific technical regulations. These policies create an uneven playing field that disadvantages U.S. companies both in China and abroad.

- **SOEs remain an essential driver of China’s economic growth.** While market-oriented reforms in China have led to a rapid expansion of the private sector, SOEs remain the driving force behind key sectors of China’s economy, with most of the largest companies in China owned or controlled by the central government.* ¹ For instance, in 2013 China’s 500 largest firms—both private and public—earned \$9.2 trillion, half of which was earned by central SOEs.² In 2014, all SOEs accounted for 17 percent of urban employment, 22 percent of industrial income, and 38 percent of China’s industrial assets.³ According to a June 2016 speech by David Lipton, the International Monetary Fund’s first deputy managing director, SOEs account for more than one-fifth of China’s total economic output.⁴ SOEs also maintain a controlling position in China’s stock markets—the ten top-valued companies in China’s Shanghai Composite Index are all state-owned.⁵ State monopolies administered by the central

* The *Fortune* Global 500, a list of the world’s largest companies by revenue, featured 98 Chinese companies in 2015. The 12 largest Chinese firms were all state-owned, while only 22 of the Chinese companies listed were privately owned. Scott Cendrowski, “China’s Global 500 Companies Are Bigger than Ever—and Mostly State-Owned,” *Fortune*, July 22, 2015. <http://fortune.com/2015/07/22/china-global-500-government-owned/>.

government are particularly important drivers of the economy, with SOE contributions in monopolized sectors like oil and gas, electricity, and tobacco reaching more than 90 percent of China's industrial output, compared to between 25 and 30 percent for the average state firm across all sectors.⁶

- **Under President Xi Jinping, the government is redoubling efforts to increase its control over private and public companies in key industries.** Despite repeated pledges to let the market play a “decisive role” in resource allocation, Beijing continues to use SOEs as a tool to pursue social, industrial, and foreign policy objectives, offering direct and indirect subsidies and other incentives to influence business decisions and achieve state goals.*⁷ These efforts are evident in China's economic reform plans, which seek to help SOEs become “bigger and stronger,” not reduce the size of the state sector.⁸ An important component of reform is to transform SOEs through “mixed ownership”—in other words, allowing private investors to take stakes. Other forms of private capital in SOEs are also welcome, including foreign capital, with SOE managers encouraged to pursue overseas mergers and acquisitions, joint investment and financing, and offshore financing.⁹ However, under these reforms, the state will maintain the “absolute controlling position” even as direct state ownership declines.¹⁰ The central government already reserves the right to appoint all senior managers in central and local SOEs, while chairmen and chief executives of these companies are often concurrently the heads of their companies' party committees, allowing the government—not market forces—to influence where resources are allocated.¹¹ An article written by the State-owned Assets Supervision and Administration Commission (SASAC) in June 2016 further highlights the power of party cells within every SOE, stating, “All the major decisions of [SOEs] must be studied and suggested by the party committees,” with “arrangements involving macro-control, national strategy and national security ... studied and discussed by the party committees before any decision by the board of directors or company management.”¹²
- **The government's influence over private companies is often underestimated.** In testimony before the Commission in February 2016, Wentong Zheng, associate professor at the University of Florida's Levin School of Law, stated that “the hallmark of Chinese state capitalism is an ecosystem in which the government is at the center of the economy and everybody else caters to the government's needs.”¹³ In this ecosystem, public and private managers alike are incentivized to foster close ties with the government.¹⁴ There are a myriad of ways the state exercises influence over private companies, including through indirect ownership of the private company via a controlling interest in a “legal person” entity,[†] an agreement among shareholders, or financial incentives.¹⁵ Huawei, for instance, is a privately held firm but receives major funding from state banks.¹⁶ Privately owned automobile manufacturer BYD Co. also benefits from state support, receiving \$108 million in 2013 from local and central government subsidies, more than 120 percent of its net profits for the year.¹⁷
- **Beijing seeks to maintain control of strategic sectors that advance the state's political and economic interests.** Economically strategic sectors (such as industrial producers) enable the government to support short-term economic growth, while politically sensitive sectors (such as telecommunications) are essential to the government's goals of advancing and controlling China's technology infrastructure, disseminating information, and protecting national security (for a list of strategic sectors identified by the Chinese government, see Appendix, “China's Strategic Sectors

* China's state goals include enhancing indigenous innovation, reducing overcapacity, and developing the country's high-technology and environmental industries, including biotechnology, high-end manufacturing equipment, and new-generation information technology (IT), among others. See U.S.-China Economic and Security Review Commission, Chapter 1, Section 3, “China's State-Led Market Reform and Competitiveness Agenda,” in *2015 Annual Report to Congress*, November 2015, 158–162.

† For more on “legal person” entities in China, see Marshall W. Meyer and Changqi Wu, “Making Ownership Matter: Prospects for China's Mixed Ownership Economy,” *Paulson Institute*, September 2014. http://www.paulsoninstitute.org/wp-content/uploads/2015/04/PPM_Making-Ownership-Matter_Meyer-and-Wu_English.pdf.

Identified in State Plans”). The higher the degree and broader the scope of a sector’s strategic value, the more likely the Chinese state will enhance its control, centralize bureaucratic coordination, and regulate market entry to achieve state goals.¹⁸ Firms operating in strategic sectors—like military industry, electrical power generation and grids, petroleum and petrochemicals, telecommunications, coal, semiconductors, civil aviation, and shipping—are the primary beneficiaries of government support.¹⁹ For instance, in the telecommunications sector, business activities are subject to heavy central-level control, and industry actors are commonly state-owned or state-controlled.²⁰ Sector-specific rules on pricing, market entry and exit, business scope, technical standards, and ownership structures maximize the advantages provided to state companies—namely, absorbing technology from foreign operators who are unable to compete within the state-promoting regulatory environment—while simultaneously enhancing state management of network infrastructure and technology.²¹

RELATIONSHIP BETWEEN STATE AND FOREIGN COMPANIES

Foreign companies have played an important role in building up and supporting the Chinese economy. According to official Chinese data, in 2015, exports and imports by foreign-invested enterprises in China accounted for 46.3 percent of the country’s total trade.²² Today, though the majority of U.S. firms still consider China a profitable market, optimism is waning.²³ While some of the difficulties—including rising labor costs and human resources constraints—cited by foreign investors in China are a normal consequence of China’s economic transition, U.S. companies doing business in China face serious challenges in the form of inconsistent and unclear legal and regulatory enforcement, market access restrictions, and preferential policies that benefit Chinese companies. In fact, China’s restrictions on foreign investment place it at the top of the Organization for Economic Co-Operation and Development’s FDI Regulatory Restrictiveness Index.²⁴ As a result, while Chinese investment flows to the United States have grown rapidly in recent years, U.S. direct investment in China appears to have slowed and even decreased.²⁵

- **China’s legal and regulatory environment continues to create an uneven playing field for U.S. companies.** U.S. investors have little to no recourse to protect their rights or fairly resolve disputes under China’s opaque legal system, which is designed to serve Chinese government interests.²⁶ Recent Chinese regulatory activities seem to disproportionately target foreign investors in strategically important industries, with China’s Anti-Monopoly Law enforcement agencies—the Ministry of Commerce, the National Development and Reform Commission, and the State Administration of Industry and Commerce—failing to treat identical or similar violations of the law equally. As a result, regulations impose substantially varied penalties on companies in similar circumstances, with more leniency toward Chinese state-owned enterprises and more rigorous enforcement against foreign companies.²⁷ For example, in its reviews of proposed mergers and acquisitions between August 2008 and the first quarter of 2014, China’s Ministry of Commerce exclusively blocked or modified transactions involving foreign companies, and imposed remedies that tend to protect and promote domestic industry and cap commodity prices and intellectual property (IP) royalties.²⁸ During this period, the Ministry of Commerce unconditionally approved 97.4 percent of the 1,006 total transactions it reviewed. All of the 26 transactions that were either rejected or conditionally approved involved foreign firms; 21 of the 26 cases involved foreign-to-foreign transactions.²⁹
- **Market access restrictions continue to limit the ability of U.S. companies to invest in China.** China restricts foreign investment in many sectors where the United States maintains a competitive advantage, such as research and development (R&D)-intensive and value-added services sectors, in order to protect domestic companies and industries. Fluctuations in China’s foreign investment restrictions follow a pattern where, at first, the government welcomes FDI into sectors deemed strategic for its national economic development in order to extract technology, IP, and know-how from foreign firms. However, after domestic industry is judged sufficiently developed, Beijing issues new policies restricting investment to push out foreign companies and free up the market for domestic firms. The automotive

industry is an example of this trend. China's industrial policies restrict foreign access to China's auto industry through requirements for technology transfers and joint ventures,^{*} but encourages foreign automotive companies to invest in China and develop Chinese brands, particularly in the new energy vehicle market.³⁰

- **China's government is introducing policies that aim to replace established market leaders with domestic firms.** The Chinese government's latest blueprint for its economy, the 13th Five-Year Plan, designates sectors such as semiconductors, biomedicines, cloud computing, mobile Internet, and e-commerce for additional government support.³¹ These policies seek to break China's dependence on imports from foreign producers in sectors where the United States currently enjoys a technological advantage. For example, U.S. multinational firms dominate the global semiconductor industry, accounting for 11 of the top 20 global semiconductor suppliers and 51 percent of the \$335.8 billion global market in 2014.³² In response, the Chinese government has established a \$19.5 billion 2014–2017 National Integrated Circuit Industry Investment Fund to provide high-level support and funding, establish national champions, and facilitate consolidation and global competitiveness of its national champions.³³ Local governments and private equity investment funds are expected to provide an additional \$97.5 billion to the fund by 2020.³⁴
- **Despite Beijing's repeated promises to open up its markets, U.S. companies believe the business climate in China is becoming less welcoming.** According to the American Chamber of Commerce in China's 2016 Business Climate Survey, 77 percent of U.S. companies reported they felt foreign businesses are less welcome in China than before, and 83 percent of technology, R&D, industrial, and resource companies reported China to be less welcoming.³⁵ This represents a dramatic increase over survey results in previous years. In 2015 and 2014, less than half of U.S. businesses stated that China was less welcoming.³⁶

CHINA'S "GOING OUT" POLICY

Even as foreign companies face growing obstacles in China, the Chinese government is encouraging domestic companies to invest abroad through policy directives and subsidization. The approval process for outbound investment has been substantially liberalized: Most Chinese companies "going out" only need to make a filing for the record rather than apply for regulatory approval.[†] As a result, Chinese investment abroad—and particularly in the United States—has spiked. By mid-June 2016, Chinese companies had already invested \$111.6 billion abroad, exceeding the \$111.5 billion invested abroad in all of 2015.³⁷ Chinese investment in the United States is expected to set a new record in 2016, with as much as \$30 billion in pending deals, up from \$15 billion in 2015.³⁸

- **Many Chinese companies investing abroad receive support from state banks and capital markets to advance state goals.** Companies in different sectors have different reasons for looking abroad: energy and resources firms aim to stabilize their domestic supply of resources and avoid price volatility, technology firms aim to acquire new technology, and manufacturing firms aim to acquire foreign brands and be closer to their target markets.³⁹ Ultimately, however, many Chinese companies are seeking government subsidies and other incentives—including low-interest bank loans and discounted

^{*} Foreign automakers can only participate in China's auto market through forming joint ventures with local partners and transferring technology to Chinese partners. U.S. China Economic and Security Review Commission, Chapter 1, Section 2, "Foreign Investment Climate in China," in *2015 Annual Report to Congress*, November 2015, 84.

[†] Some restrictions remain. For example, outbound investments exceeding \$1 billion still require approvals, as do projects of any amount in so-called "sensitive countries and regions" (including countries with which China has not established formal diplomatic relations, countries subject to international sanctions, and countries in state of war or internal unrest) or "sensitive industries" (including telecommunications, water management, large-scale land development, electrical power transmission, and news media). Marc Szepan, "China's New Overseas Investment Approval Rules: China's Big Deals Are Likely to Become an Even Bigger Deal," *MERICs*, April 15, 2014.

means of production—as a reward for furthering state goals.⁴⁰ Because these foreign acquisitions are aided by preferential government treatment and financial support from Chinese banks—thereby lowering SOEs’ cost of capital and subsidizing production costs—Beijing’s policies give Chinese companies a competitive advantage over U.S. and other private firms.⁴¹ These foreign investments also increase SOE debt in China, with companies relying on risky loans from state banks to finance the deals.⁴²

- **Chinese foreign investment is focused in strategic sectors.** The degree and scope of a sector’s perceived strategic value establishes a framework for China’s global integration, emphasizing the most valuable foreign investment opportunities for Chinese leadership.⁴³ Most of China’s largest bids for foreign investment to date have been in strategic sectors like biotechnology (e.g., the \$43 billion deal for the Swiss biotech and agriculture firm Syngenta), electronics (including a failed \$3.3 billion deal for a majority interest in Philips’ combined LED components and lighting business), and agriculture (most notably the 2013 acquisition of Smithfield Foods for \$4.7 billion). Through May 2016, Chinese mergers and acquisitions (M&As) have largely taken place in strategic sectors, with nearly \$50 billion invested in agribusiness and over \$10 billion in technology, more than half of China’s total M&As in 2016.⁴⁴ China has also actively pursued investments in the semiconductor industry, but the largest bids (including a \$23 million offer for chipmaker Micron and a \$2.5 billion bid for Silicon Valley-based Fairchild Semiconductor International) have been rejected or withdrawn over fears they would be blocked by U.S. regulators.⁴⁵ Focusing its foreign investment in strategic sectors enables Beijing to move up the value chain in high-tech sectors without having to develop domestic innovations.⁴⁶

CONCLUSIONS AND RECOMMENDATIONS

China has benefitted tremendously from past economic liberalization and its close trading relationship with the United States. These are not abstract concepts: Witness China’s massive trade surpluses, rising outward FDI, and burgeoning soft power. Several decades of economic prosperity have also fueled China’s rapid military modernization and growing strategic assertiveness, most evident in the territorial disputes in the South China Sea and East China Sea. There is no mistaking the fact that, having enjoyed the benefits of an open global trading system supported by the United States, China has been building up military and other capabilities to challenge the United States. How should we respond? This is a weighty question that deserves far more attention from policymakers than it currently receives.

Today, China’s leadership seems to have forgotten the critical role economic reform has played in China’s own success story: The Xi Administration is focused on strengthening the government’s grip on the economy, while eschewing needed economic reforms. Ultimately, for China’s government, economic reform does not mean a freer market. Instead, it means that while some sectors of the economy will be subject to market discipline, the government—and, more importantly, the Chinese Communist Party—intends to retain control.

The worsening investment climate in China has been accompanied by rising censorship and tightening restrictions on freedom of information. Most recently, China has sought to control the activities of foreign nongovernment organizations (NGOs) through a newly passed NGO law.⁴⁷ The law gives Chinese authorities broad powers to close NGOs, requires foreign NGOs to register with the Chinese government, and empowers Chinese police to search a foreign NGO’s finances and operations at any time.⁴⁸ China has also cracked down on Internet privacy and freedom of the press, with Roseann Rife, East Asia research director at Amnesty International, warning, “Chinese authorities are trying to rewrite the rules of the Internet so censorship and surveillance become the norm everywhere.”⁴⁹

Chinese government’s efforts to censor content it finds objectionable are spilling over its borders. A Commission report released in October 2015 titled “Directed by Hollywood, Edited by China: How China’s Censorship and Influence Affect Films Worldwide” details American filmmakers’ increasing tendency to

edit films in anticipation of Chinese censors' potential sensitivities.⁵⁰ C. Robert Cargill, an American screenwriter, says Hollywood executives can either bend to China's demands or else "risk alienating one billion people ... and risk the Chinese government going, 'Hey, you know one of the biggest film-watching countries in the world? We're not going to show your movie because you decided to get political.'"⁵¹

Members of Congress have a difficult task ahead of them in determining the future course of the U.S.-China economic relationship. Let me give you just one example: The United States and China are negotiating a Bilateral Investment Treaty (BIT), which the U.S. Senate would have to approve by a two-thirds majority. The BIT could increase U.S. investment in China and Chinese FDI in the United States—with potentially positive outcomes for the U.S. economy. However, a number of significant challenges complicate the debates around a prospective U.S.-China BIT. These include Chinese government's control over key sectors of its economy; Chinese policies granting preferential treatment to domestic companies, or forcing foreign companies to transfer technology in exchange for market access; and China's history of poor compliance with its international commitments.

With that in mind, I want to offer a few recommendations to ensure U.S. companies and workers continue to enjoy a level playing field.

- The USTR needs to be more assertive in bringing enforcement cases against China when it violates its WTO commitments. Companies are often reluctant to complain because they fear retribution from the Chinese government. Congress should therefore encourage the USTR to bring cases whenever U.S. interests are being hurt, even if U.S. companies will not speak up.
- U.S. policymakers should identify areas where stronger legal tools are needed to counter China's trade-distorting practices—including industrial policies, abusive legal or administrative processes, and discriminatory treatment of foreign investors—and implement them domestically and at the WTO. It is particularly important to focus on ensuring that small and medium enterprises, which often lack resources to pursue claims, have sufficient access to remedies if they have been negatively affected by Chinese trade-distorting practices.
- The United States should develop a more results-oriented approach to dealing with China's trade-distorting practices. We should identify our goals and pursue them in a comprehensive way—through dialogue and enforcement actions—setting specific, quantifiable commitments to keep China accountable.
- The United States should build coalitions with other trading partners to challenge China's unfair trade practices in multilateral fora and on a bilateral basis, including through the WTO. This approach was successful at convincing the Chinese government to suspend restrictive banking-sector IT guidelines which would have forced foreign suppliers to share source code with Chinese regulators. We should use it again to address other persistent challenges, including recent restrictions on the operations of NGOs.

Mr. Chairman, Ranking Member Brown, Members of the Committee, thank you again for the opportunity to be here today and to discuss the work the Commission is doing on behalf of Congress. I look forward to your questions.

Appendix: China's Strategic Sectors Identified in State Plans

<u>Made in China 2025</u> <u>(2015)</u>	<u>Strategic Emerging</u> <u>Industries (2010)</u>	<u>Strategic Industries</u> <u>(2006)</u>	<u>Heavyweight</u> <u>Industries (2006)</u>
(1) Clean energy vehicles (2) Next-generation IT (3) Biotechnology (4) New materials (5) Aerospace (6) Ocean engineering and high-tech ships (7) Railway (8) Robotics (9) Power equipment (10) Agricultural machinery	(1) Clean energy technologies (2) Next-generation IT (3) Biotechnology (4) High-end equipment manufacturing (5) Alternative energy (6) New materials (7) Clean energy vehicles	(1) Armaments (2) Power generation and distribution (3) Oil and petrochemicals (4) Telecommunications (5) Coal (6) Civil aviation (7) Shipping	(1) Machinery (2) Automobiles (3) IT (4) Construction (5) Iron, steel, and nonferrous metals

Source: State Council of the People's Republic of China, *Made in China 2025*, May 8, 2015. http://www.gov.cn/zhengce/content/2015-05/19/content_9784.htm; U.S.-China Economic and Security Review Commission, *Hearing on China's Five-Year Plan, Indigenous Innovation and Technology Transfers, and Outsourcing*, written testimony of Willy C. Shih, June 15, 2011; U.S.-China Economic and Security Review Commission, *Hearing on the Extent of the Government's Control of China's Economy, and Implications for the United States*, written testimony of George T. Haley, May 24–25, 2007; and U.S.-China Economic and Security Review Commission, Chapter 1, Section 1, "The Relationship's Current Status and Significant Changes during 2007," in *2007 Annual Report to Congress*, November 2007, 38–39.

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