

Tab D

Chapter 1: U.S.-China Economic and Trade Relations

Section 2: State-Owned Enterprises, Overcapacity, and China's Market Economy Status

FINAL draft to Commissioners – sent October 07, 2016

Please place behind **Tab D** in the 2016 Annual Report Binder

Introduction

In China's centralized, state-run economic system, the government's legitimacy is closely tied to its ability to deliver high levels of economic growth. With China's economy slowing down, the government is facing a difficult choice between maintaining short-term growth and undertaking economic restructuring. The Chinese Communist Party (CCP) appears to have chosen the former path. Although the CCP has repeatedly announced new policies to address structural problems in the country's economy, it has failed to implement changes that meaningfully put the economy on a path to becoming market led. This is because the CCP's reform efforts are aimed at managing its state-led system, not transitioning toward a market-led economy.

In the reforms announced to date, Beijing has sought to take superficial steps toward privatization and improved efficiency, while increasing government control over the economy. The country's large and inefficient state-owned enterprises (SOEs) epitomize this trend: SOEs contribute a sizable share of the country's jobs and revenue, but are in need of significant restructuring to reduce mounting debt levels resulting from a legacy of imbalanced, government-led growth. However, it is increasingly evident that the top CCP leadership does not want to implement free market SOE reforms.

To date, the CCP has not demonstrated a commitment to a free market economy as a matter of principle, and powerful practical considerations mitigate against reform efforts. SOEs in strategic sectors are the primary entities through which the CCP directs the economy towards the regime's strategic ends; real reform in these sectors would mean giving up control and dramatically reducing the government's ability to achieve the goals identified in the 13th Five-Year-Plan (FYP). Reforms would also reduce the size of the state sector, creating significant job losses at a time when economic growth is already slowing. Finally, huge political obstacles in the form of entrenched interests resist any substantial changes in SOEs' structure that might reduce the CCP's control. For all of these reasons, what passes for reforms of SOEs has taken the form of consolidating state control and pressuring firms to act in line with government interests. As a result, in response to CCP policies, the Chinese government continues to subsidize the state sector despite warnings from the International Monetary Fund (IMF) that effects from a large wave of SOE defaults could ripple through the global economy.

The need for reform is particularly pressing in China's heavy industries, where years of government subsidies have created overcapacity and market distortions. China's industrial capacity, for instance, has suppressed global commodity prices and hindered global industrial activity. Rampant overcapacity also poses a national security risk to the United States, as cheap Chinese steel and finished aluminum product imports threaten to hollow out the domestic industries and weaken the national defense industrial base.

To offset Beijing's anticompetitive policies, the United States and other major Chinese trading partners are increasingly using trade remedies like antidumping and countervailing duties. In December 2016, however, the provision of China's WTO accession protocol enabling countries to automatically treat China as a nonmarket economy expires, sparking debate among Chinese, U.S., and European officials about the future of China's market economy status.

Drawing on expert testimony received at the Commission's February 24, 2016, hearing on "China's Economic Realities and Implications for the United States," information from the Commission's fact-finding trip to China in June 2016, and additional research throughout the year, this section explores the implications of China's economic decision making for U.S. firms, industry, and consumers, as well as for the global economy.

China's State Capitalism in the Global Context

As China's economic growth—reported to be 6.7 percent¹ in the first half of 2016 compared to the first half of 2015, according to official Chinese data—hits its lowest level in 25 years, inefficient and debt-ridden SOEs have become one of the most pressing problems facing the Chinese government.² 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.³ During the Commission's June 2016 trip, Chinese government officials acknowledged that China would benefit from some deregulation and privatization of its state-owned enterprises.⁴ However, the government's continued reluctance to revoke SOEs' privileged status in the economy has created imbalances in global markets, hindering efforts by private domestic and foreign firms to compete in and outside China.

¹ **FOOTNOTE:** Most private estimates put China's economic growth far below 6.7 percent. For example, the economic research firm Capital Economics estimates China's gross domestic product (GDP) grew only 4.5 percent in the second quarter of 2016. Sue Chang, "China's Economy Likely Lost More Momentum amid Mounting Debt," *MarketWatch*, July 13, 2016. <http://www.marketwatch.com/story/chinas-economy-likely-lost-more-momentum-amid-mounting-debt-2016-07-13>.

² Mark Magnier, "China GDP Sends Troubling Signal on Economic Reform," *Wall Street Journal*, July 15, 2016. <http://www.wsj.com/articles/massive-stimulus-keeps-china-gdp-steady-in-second-quarter-1468549521>; Mark Magnier, "China's Economic Growth in 2015 Is Slowest in 25 Years," *Wall Street Journal*, January 19, 2016. <http://www.wsj.com/articles/china-economic-growth-slows-to-6-9-on-year-in-2015-1453169398>.

³ Gisela Grieger, "State-Owned Enterprise (SOE) Reforms in China: A Decisive Role for the Market at Last?" *European Parliament Think Tank*, May 31, 2016.

⁴ Chinese officials, meeting with Commission, Beijing, China, June 24, 2016; Xinhua, "Chinese Leaders Emphasize Efforts to Deepen SOE Reform," July 4, 2016. http://news.xinhuanet.com/english/2016-07/04/c_135488264.htm.

Current State of Chinese SOEs

State-owned and state-controlled companies remain significant contributors to China's economic growth, providing a substantial source of China's revenue and employment. In 2014, all SOEs accounted for 17 percent of urban employment, 22 percent of total industrial profits [with industrial production accounting for 42.7 percent of gross domestic product (GDP) in 2014] and 38 percent of China's industrial assets.⁵ Using official Chinese data, Nicholas Lardy, senior fellow at the Peterson Institute for International Economics, estimates state firms contribute between 25 and 30 percent of China's industrial output on average, although SOE contribution in some monopoly sectors can exceed 90 percent.⁶ Likewise, SOEs maintain a controlling position in China's stock markets—the ten top-valued companies by market capitalization in China's Shanghai Composite Index are state owned.⁷ Chinese SOEs are also present on U.S. stock exchanges. For example, there are 14 Chinese SOEs listed on the New York Stock Exchange, including PetroChina, China Mobile, Sinopec, and China Telecom.⁸

Many Chinese companies operate in gray zones between private and public ownership, with both SOEs and private companies receiving incentives to execute government objectives, making it difficult to delineate state-owned and private businesses.⁹ Still, SOEs remain the driving force behind sectors of fundamental importance to the Chinese economy, with most of the largest companies by revenue owned or controlled by the central government.¹⁰ Large state monopolies in sectors like oil and gas, electricity, and tobacco, for instance, contribute to SOEs' disproportionately large share of China's economic growth.¹¹ In 2013, one-third of total SOE assets were controlled by the 113 SOEs administered by the central State-Owned Assets Supervision and Administration Commission (SASAC), while the remaining assets were controlled by SOEs administered by local governments and other government ministries, including financial institutions, cultural institutions, the national postal system, and the national tobacco monopoly.¹² According to a recent

⁵ Grace Tam, Katy Fang, and Tai Hui, "China: Reform Unlocks the Value of State-Owned Enterprises," *JP Morgan Chase*, March 30, 2015. https://www.jpmorganmf.com/GTMA/MI-MB_China_SOEReform_20150330.pdf; National Bureau of Statistics via CEIC database.

⁶ Wendy Leutert, "Challenges Ahead in China's Reform of State-Owned Enterprises," *Asia Policy* 21 (January 2016): 86; Peter Orszag, "Private Companies Are Driving China's Growth," *Bloomberg View*, October 14, 2015. <http://www.bloombergvie.com/articles/2014-10-14/private-companies-are-driving-china-s-growth>.

⁷ Scott Cendrawski, "Here's What You May Not Know about the Chinese Stock Market," *Fortune*, September 2, 2015. <http://fortune.com/2015/09/02/heres-what-you-may-not-know-about-the-chinese-stock-market/>.

⁸ Nasdaq, "Companies in China." <http://www.nasdaq.com/screening/companies-by-region.aspx?region=Asia&country=China>; Paul L. Gillis, *The Big Four and the Development of the Accounting Profession in China*, Emerald Group Publishing, February 21, 2014, 132.

⁹ U.S.-China Economic and Security Review Commission, *Hearing on China's Shifting Economic Realities and Implications for the United States*, oral testimony of Wentong Zheng, February 24, 2016.

¹⁰ U.S.-China Economic and Security Review Commission, *Hearing on China's Shifting Economic Realities and Implications for the United States*, oral testimony of Paul Hubbard, February 24, 2016.

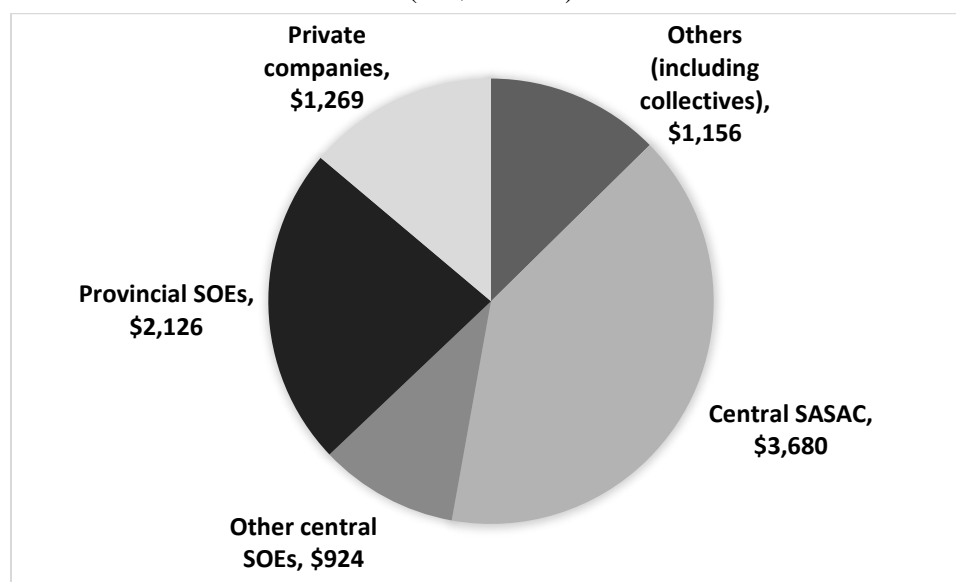
¹¹ Paul Hubbard, "Where Have China's State Monopolies Gone?" *East Asian Bureau of Economic Research (Working Paper)*, November 3, 2015, 27.

¹² Paul Hubbard and Patrick Williams, "Chinese State-Owned Enterprises: An Observer's Guide," *East Asian Bureau of Economic Research Working Paper* 108 (August 2015): 8; Gabriel Wildau, "China Cautiously Embraces Privatization of

study by Paul Hubbard, a scholar at the Australian National University, China's 500 largest firms—both private and public—earned \$9.2 trillion in 2013.¹³ Of that \$9.2 trillion, only 14 percent was earned by private companies (see Figure 1).¹⁴

Figure 1: Revenue of China's Top 500 Firms by Ownership, 2013

(US\$ billions)



Source: U.S.-China Economic and Security Review Commission, *Hearing on China's Shifting Economic Realities and Implications for the United States*, written testimony of Paul Hubbard, February 24, 2016.

SOEs' Growing Debt Problem

Despite the controlling status enjoyed by some SOEs in China's economy—largely due to their monopolistic market positions and barriers for private sector competitors—inefficiency and mismanagement of assets run rife. Because SOEs are given access to cheap financing and lower interest rates¹⁵ in return for delivering investments and public services in line with government interests, they often operate based on state preferences rather than market principles.¹⁶ As a result, Chinese SOEs face growing corporate debt, sluggish demand, weak pricing, and high leverage.¹⁷ SOE profits have been steadily

State-Owned Enterprises," *Financial Times*, September 25, 2015. <https://www.ft.com/content/69253d76-633c-11e5-97e9-7f0bf5e7177b>.

¹³ U.S.-China Economic and Security Review Commission, *Hearing on China's Shifting Economic Realities and Implications for the United States*, written testimony of Paul Hubbard, February 24, 2016.

¹⁴ U.S.-China Economic and Security Review Commission, *Hearing on China's Shifting Economic Realities and Implications for the United States*, written testimony of Paul Hubbard, February 24, 2016.

¹⁵ **FOOTNOTE:** According to an August 2016 IMF report, implicit government financing guarantees grant SOEs an estimated 4 to 5 notch credit rating upgrade (i.e., a B- rating under Standard & Poor's rating system would be upgraded to a BB or BB+) and lower SOE borrowing costs by 1 to 2 percentage points. International Monetary Fund, *The People's Republic of China: 2016 Article IV Consultation: Selected Issues*, August 2016, 33.

¹⁶ International Monetary Fund, *The People's Republic of China: 2016 Article IV Consultation: Selected Issues*, August 2016, 33.

¹⁷ James Kynge, "Corporate Credit Shock Beckons for China," *Financial Times*, January 26, 2016. <http://www.ft.com/intl/cms/s/0/3497c2c0-c446-11e5-808f-8231cd71622e.html#axzz3zlyFhAbx>.

declining in recent years, falling 6.7 percent year-on-year in 2015 and 8.5 percent year-on-year in the first half of 2016.¹⁸ To remain viable, many SOEs are reliant on loans from state banks, leading to the proliferation of “zombie” companies¹⁹ that require constant bailouts to operate. Since 2008, nonfinancial SOEs have increased their loans relative to assets from 53 percent to 64 percent—nearing the United States’ 70 percent debt-to-asset ratio before the 2008–2009 financial crisis—while private companies’ loans relative to assets declined over the same period.²⁰

According to a June 2016 speech by David Lipton, First Deputy Managing Director of the IMF, “corporate debt [in China] remains a serious—and growing—problem that must be addressed immediately and with a commitment to serious reforms.”²¹ In the first quarter of 2016, corporate debt for all Chinese companies rose to 169 percent of GDP (up from 108 percent in 2008), compared to 72 percent in the first quarter of 2016 for the United States.²² Dr. Lipton’s speech indicates that SOEs account for around 55 percent of corporate debt.²³ According to Chinese regulators, nonperforming loans (NPLs) held by Chinese banks amounted to \$300 billion, or 2.15 percent of total loans, at the end of May 2016.²⁴ Although China’s official NPL ratio is down from 7.5 percent at the end of 2006, the actual NPL ratio may be much higher.²⁵ Ultimately, Dr. Lipton concluded that Chinese SOEs are “essentially on life support,” warning that if the problem is not dealt with soon it could evolve into a larger crisis.²⁶ As a result of surging debt and stagnant reforms, Standard & Poor’s ratings agency cut the outlook for China’s credit rating from stable to negative in March 2016, following similar revisions by Moody’s Investors Service earlier that month.²⁷

¹⁸ Xinhua, “China’s SOE Profits Post Milder Decline,” July 25, 2016. http://news.xinhuanet.com/english/2016-07/25/c_135538890.htm; Mark Magnier, “IMF Warns China of Risks of Mounting Corporate Debt,” *Wall Street Journal*, June 12, 2016. <http://www.wsj.com/articles/imf-warns-china-of-risks-of-mounting-corporate-debt-1465613146>.

¹⁹ **FOOTNOTE:** A “zombie” company generates only enough revenue to repay the interest on its debt. Because banks are reluctant to take the losses from a write-down of this debt and apply forbearance, these indebted firms are given additional time to repay loans. Hugh Pym, “Zombie Companies Eating Away at Economic Growth,” *BBC*, November 13, 2012. <http://www.bbc.com/news/business-20262282>.

²⁰ Wenland Zhang et al., “Corporate Leverage in China: Why Has It Increased Fast in Recent Years and Where Do the Risks Lie?” *Hong Kong Institute for Monetary Research* (Working Paper), April 2015, 2, 16. http://www.hkimr.org/uploads/publication/416/wp-no-10_2015-final-.pdf.

²¹ David Lipton, “Rebalancing China: International Lessons in Corporate Debt,” *International Monetary Fund*, June 2016. <http://www.imf.org/external/np/speeches/2016/061016.htm>; *Wall Street Journal*, “China’s Debt Bomb,” June 28, 2015. <http://www.wsj.com/articles/chinas-debt-bombs-1435512036>.

²² Bank of International Settlements, “Credit to the Non-Financial Sector,” September 18, 2016. <https://www.bis.org/statistics/totcredit.htm?m=6%7C326>.

²³ David Lipton, “Rebalancing China: International Lessons in Corporate Debt,” *International Monetary Fund*, June 2016. <http://www.imf.org/external/np/speeches/2016/061016.htm>.

²⁴ Jiang Xueqing, “Regulators Tighten Bank Risk Management, Warn on Asset Bubbles,” *China Daily*, July 8, 2016. http://english.gov.cn/state_council/ministries/2016/07/08/content_281475388766074.htm.

²⁵ Jiang Xueqing, “Regulators Tighten Bank Risk Management, Warn on Asset Bubbles,” *China Daily*, July 8, 2016. http://english.gov.cn/state_council/ministries/2016/07/08/content_281475388766074.htm; China Banking Regulatory Commission, *2006 Annual Report*, May 15, 2007, 14. <http://zhuanqi.cbrc.gov.cn/subject/subject/nianbao/english/ywqb.pdf>.

²⁶ David Lipton, “Rebalancing China: International Lessons in Corporate Debt,” *International Monetary Fund*, June 2016. <http://www.imf.org/external/np/speeches/2016/061016.htm>.

²⁷ Malcolm Scott, “China Rating Outlook Cut at S&P on Risk of Slow Rebalancing,” *Bloomberg Markets*, March 31, 2016. <http://www.bloomberg.com/news/articles/2016-03-31/china-rating-outlook-cut-at-s-p-on-risk-of-slower-rebalancing>.

Efforts to Address Debt

China has begun allowing some state-owned companies to default to incentivize more prudent investing by SOEs and by other companies in SOEs.²⁸ Baoding Tianwei Group, a power generation equipment company, became the first SOE to default on bonds when it missed a \$13 million interest payment in September 2015.²⁹ Two months later, state-owned China Shanshui Cement Group defaulted on a \$300 million loan.³⁰ In March 2016, Guangxi Nonferrous Metals Group Co.—which had been receiving state aid since 2012—defaulted on \$2.3 billion of its debt, and Dongbei Special Steel, a state-owned steelmaker in Liaoning Province, defaulted on its corporate debt for the seventh time on payments worth a total of \$715 million across all seven defaults.³¹ According to Bloomberg, the total number of Chinese companies with more debt than equity jumped to 913 in 2015, a nearly 30 percent increase since 2007.³² As a result, total bond defaults have skyrocketed, with 34 defaults accounting for around \$3 billion in China's domestic bond market—including both SOEs and private enterprises—in the first half of 2016, nearly double the number of defaults in all of 2015.³³ In September 2016, state-owned Guangxi Nonferrous Metals Group Co. became the first company liquidated by Beijing after it could not reach an agreement with investors to bail out the company following its March 2016 default.³⁴ China's central bank governor, Zhou Xiaochuan, has expressed concern over the highly leveraged state of the economy, encouraging the development of "robust capital markets" to reduce China's reliance on debt and increase equity financing.³⁵

Notwithstanding rising debt levels, Chinese companies are increasingly acquiring foreign companies in strategic sectors to earn government subsidies and other incentives.³⁶ SOEs in different sectors have varying reasons for looking abroad: energy and resources firms aim to stabilize their domestic supply of resources,

²⁸ Joe McDonald, "Chinese Financial Reforms Collide with 'Too Big to Fail,'" Associated Press, November 19, 2015. <http://bigstory.ap.org/article/3873fcb5d1ed4c2facfd31fe896aca6b/chinese-financial-reforms-collide-too-big-fail>.

²⁹ Gabriel Wildau, "China State Group Bailout Highlights Urgency of Reform," *Financial Times*, September 22, 2015. <http://www.ft.com/intl/cms/s/0/921b3fe4-60eb-11e5-97e9-7f0bf5e7177b.html#axzz42ykxjLMi>.

³⁰ Joe McDonald, "Chinese Financial Reforms Collide with 'Too Big to Fail,'" Associated Press, November 19, 2015. <http://bigstory.ap.org/article/3873fcb5d1ed4c2facfd31fe896aca6b/chinese-financial-reforms-collide-too-big-fail>.

³¹ Gabriel Wildau, "Chinese Default Exposes Creditor Anger at Political Interference," *Financial Times*, July 27, 2016. <http://www.ft.com/cms/s/0/47a20c94-53cb-11e6-9664-e0bdc13c3bef.html#axzz4G72hFkVy>; Valentin Schmid, "More Bad China Debt News: SOE Defaults on \$2.3 Billion," *Epoch Times*, March 23, 2016. <http://www.theepochtimes.com/n3/2001223-more-bad-china-debt-news-soe-defaults-on-2-3-billion/>.

³² Bloomberg Business, "Chinese Bond Defaults Seen Rising as Borrowing Costs Climb," December 28, 2015. <http://www.bloomberg.com/news/articles/2015-12-28/china-bond-defaults-seen-rising-as-borrowing-costs-climb-in-2016>.

³³ Sean Miner, "Chinese Bond Market Defaults Rise in First Half of 2016," *Peterson Institute for International Economics*, June 30, 2016. https://piie.com/blogs/china-economic-watch/chinese-bond-market-defaults-rise-first-half-2016?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+ChinaEconomicWatch+%28PIIE+China+Economic+Watch%29.

³⁴ Zhang Yu, "Guangxi Nonferrous Metals Gets Court OK to Liquidate," *Caixin*, September 20, 2016. <http://english.caixin.com/2016-09-20/100990098.html>.

³⁵ Patti Waldmeir, "China Bank Governor Warns over Corporate Debt," *Financial Times*, March 20, 2016. <http://www.ft.com/intl/cms/s/0/3bb2893c-ee80-11e5-9f20-c3a047354386.html#axzz43XfN0W83>.

³⁶ James Kyngé, "M&A: China's World of Debt," *Financial Times*, February 11, 2016. <http://www.ft.com/intl/cms/s/0/4c9642f6-d0a9-11e5-831d-09f7778e7377.html?siteedition=intl#axzz42EEOm7XZ>.

avoid price volatility, and learn about new resource extraction methods; technology firms aim to acquire new technology; and manufacturing firms aim to be closer to their target markets and mitigate concerns over protectionism.³⁷ For example, China National Chemical Corporation's (ChemChina) \$43 billion takeover of Swiss seed giant Syngenta AG likely seeks to boost China's farm productivity.³⁸ The Syngenta deal may also allow China to monopolize the development of genetically modified crops. In February 2016, China's Tianjin Tianhai Investment Co. made a bid for the U.S. electronics firm Ingram Micro, Inc. to boost China's domestic technology capabilities and reduce imports of high-tech products (for a list of Chinese bids and acquisitions of U.S. companies, see Chapter 1, Section 1, "Year in Review: Economics and Trade").³⁹ By acquiring businesses in line with the Chinese government's industrial policy,⁴⁰ SOEs earn support from Beijing, including backing from state banks and capital markets.⁴¹ These deals ultimately increase SOE debt in China, with companies sometimes relying on extremely risky loans from state banks to finance the deals.⁴² China has also announced new policies aimed at reducing banks' NPL ratios, including a securitization program and debt-for-equity swaps (for more on government efforts to address China's debt problem, see Chapter 1, Section 3, "China's 13th Five-Year Plan").⁴³ These measures are expected to have a limited impact on overall debt, however, with investors noting they expect little global appetite for high-risk Chinese debt.⁴⁴

SOE Reform Agenda

SOEs have been a target of reform for years, with the government repeatedly promising to address the growing problems inherent in its state-led model. In meetings with the Commission, Chinese officials reaffirmed the government's intent to undertake institutional SOE reforms.⁴⁵ Nevertheless, evidence shows

³⁷ Shuping Liao and Yongsheng Zhang, "A New Context for Managing Overseas Direct Investment by Chinese State-Owned Enterprises," *East Asian Bureau of Economic Research* 83 (August 2013): 13.

³⁸ Brian Spegele and Kathy Chu, "ChemChina-Syngenta \$43 Billion Deal Approved by U.S. Security Panel," *Wall Street Journal*, August 22, 2016. <http://www.wsj.com/articles/u-s-security-watchdog-clears-43-billion-chemchina-syngenta-takeover-deal-1471844896>.

³⁹ Ian King, "Ingram Micro to Be Bought by Tianjin Tianhai for \$6 Billion," *Bloomberg Technology*, February 17, 2016. <http://www.bloomberg.com/news/articles/2016-02-17/ingram-micro-to-be-acquired-by-tianjin-tianhai-for-6-billion>.

⁴⁰ **FOOTNOTE:** China's industrial policy seeks to enhance indigenous innovation, reduce overcapacity, and develop the country's high-technology and environmental industries, including biotechnology, high-end manufacturing equipment, and new-generation information technology. 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.

⁴¹ James Kynge, "M&A: China's World of Debt," *Financial Times*, February 11, 2016. <http://www.ft.com/intl/cms/s/0/4c9642f6-d0a9-11e5-831d-09f7778e7377.html?siteedition=intl#axzz42EEOm7XZ>.

⁴² James Kynge, "M&A: China's World of Debt," *Financial Times*, February 11, 2016. <http://www.ft.com/intl/cms/s/0/4c9642f6-d0a9-11e5-831d-09f7778e7377.html?siteedition=intl#axzz42EEOm7XZ>.

⁴³ Shawn Donnan, "IMF Sounds Warning on China's Corporate Debt," *Financial Times*, June 12, 2016. <http://www.ft.com/intl/cms/s/0/3f8dcf22-304c-11e6-bda0-04585c31b153.html#axzz4BTMEOTI3>.

⁴⁴ Don Weinland, "China Plans Securitisation to Tackle Banks' Bad Debt Burden," *Financial Times*, March 3, 2016. <https://www.ft.com/content/7deb7a6e-e116-11e5-8d9b-e88a2a889797>.

⁴⁵ Chinese officials, meeting with Commission, Beijing, China, June 24, 2016; Xinhua, "Chinese Leaders Emphasize Efforts to Deepen SOE Reform," July 4, 2016. http://news.xinhuanet.com/english/2016-07/04/c_135488264.htm.

Beijing has effectively abandoned its boldest proposals for restructuring the state sector, with a number of reforms still not implemented despite years of repeated promises by high-ranking officials.⁴⁶ At a State Council executive meeting in May 2016, China's Premier Li Keqiang discussed SOE reform measures aimed at improving competition, creating a favorable environment for innovation, and promoting efficient deployment of assets.⁴⁷ These steps—along with promises to streamline SOE management and corporatize⁴⁸ the state sector—echo past SOE reform efforts that continue to be repackaged and re-announced.⁴⁹ At the November 2013 Third Plenary Session of the 18th CCP Central Committee (Third Plenum), for example, Chinese President and General Secretary of the CCP Xi Jinping announced an SOE reform plan that called for ownership diversification and withdrawal of SOEs from sectors with healthy, competitive environments.⁵⁰ Three years later, Beijing has still not produced an official list of competitive sectors, indicating the withdrawal of state ownership is unlikely.⁵¹ In September 2015, China's State Council released the "Guiding Opinion on Deepening SOE Reform," a high-level policy document that once again set forth a familiar plan for SOE reform that lacked detail and a clear timeline for implementation.⁵²

The central tenet of the September 2015 reform plan is to help SOEs become "bigger and stronger," not to reduce the size of the state sector.⁵³ According to Mr. Hubbard, reforms "are designed to simultaneously reduce the interference of the state at a bureaucratic level but reinstitute or strengthen Party leadership."⁵⁴ A June 2016 article in *Qiushi*, a bimonthly magazine published by the Central Party School and the Central Committee of the CCP, highlighted the growing power of party cells within SOEs, indicating "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

⁴⁶ Arthur Kroeber, "Making Sense of the Economic Policy Mess," *China Economic Quarterly*, 20:2 (June 2016): 3.

⁴⁷ State Council of the People's Republic of China, "Li Keqiang Chairs State Council Executive Meeting," May 18, 2016. Staff translation. http://www.gov.cn/guowuyuan/2016-05/18/content_5074482.htm.

⁴⁸ **FOOTNOTE:** In 1994, the Chinese government began converting SOEs into corporate firms and creating mixed-ownership enterprises. Curtis Milhaupt and Wentong Zheng, "Why Mixed-Ownership Reforms Cannot Fix China's State Sector," *Paulson Policy Memorandum*, January 2016, 4.

⁴⁹ Curtis Milhaupt and Wentong Zheng, "Why Mixed-Ownership Reforms Cannot Fix China's State Sector," *Paulson Policy Memorandum*, January 2016, 1.

⁵⁰ Daniel Dusek, Peter Huang, and Andre Zhu, "China M&A: Reform Plan Promotes Mixed Ownership of State-Owned Enterprises," *Skadden's 2015 Insights—Global M&A*, January 2015. <https://www.skadden.com/insights/china-ma-reform-plan-promotes-mixed-ownership-state-owned-enterprises>.

⁵¹ Daniel Dusek, Peter Huang, and Andre Zhu, "China M&A: Reform Plan Promotes Mixed Ownership of State-Owned Enterprises," *Skadden's 2015 Insights—Global M&A*, January 2015. <https://www.skadden.com/insights/china-ma-reform-plan-promotes-mixed-ownership-state-owned-enterprises>.

⁵² Xinhua, "State Council of the Chinese Communist Party Releases 'Guiding Opinion on Deepening SOE Reform,'" September 13, 2015. Staff translation. http://news.xinhuanet.com/politics/2015-09/13/c_1116547080.htm.

⁵³ David Keohane, "SOE You Think You Can Reform? Mixed-Ownership Edition," *FT Alphaville* (Financial Times blog), September 28, 2015. <http://ftalphaville.ft.com/2015/09/28/2140985/soe-you-think-you-can-reform-mixed-ownership-edition/>.

⁵⁴ U.S.-China Economic and Security Review Commission, *Hearing on China's Shifting Economic Realities and Implications for the United States*, oral testimony of Paul Hubbard, February 24, 2016.

before any decision by the board of directors or company management.”⁵⁵ In addition, the 13th FYP released in April 2016 highlighted state control of SOEs as one of its key reform priorities (for more on the 13th FYP, see Chapter 1, Section 3 “13th Five-Year-Plan”).⁵⁶ Specific reform plans outlined by Beijing include:

Mixed-ownership reforms: To improve management, SOEs in industries deemed by the State Council to have sufficient market competition will actively pursue foreign capital in restructuring through methods including overseas mergers and acquisitions, joint investment and financing, and offshore financing. However, state capital will maintain the “absolute controlling position,” suggesting that even in the absence of full state ownership, SOEs will continue to be controlled by the state.⁵⁷ The guidelines aim to complete mixed-ownership reforms for all SOEs by 2020.⁵⁸

Mixed-ownership reforms are not expected to result in full privatization of SOEs. One example of the limitations of mixed-ownership reforms is the case of Jiangxi Salt, a legal monopoly in China’s salt market previously owned by the Jiangxi provincial SASAC. After a deal in September 2015 to open the company to foreign investors—hailed by official media as a landmark example of SOE reform—Jiangxi SASAC’s share in the company dropped from 100 to 47 percent, with four outside investors collectively holding a 47 percent stake and Jiangxi Salt’s management buying a 6 percent stake.⁵⁹ However, of the four new investors, three were SOEs administered by SASAC, while the fourth was 83 percent owned by the Ministry of Finance.⁶⁰ Rather than selling assets to new investors and raising money for the local government, the Jiangxi deal was primarily structured as a capital injection, thereby undermining an intended result of SOE reform to help reduce local government debt by selling state assets.⁶¹ Ultimately, “mixed-investment” SOEs have negligible amounts of private capital, with the state maintaining its control over business activities.⁶²

⁵⁵ Xu Gaofeng, “Identifying State-Owned Enterprises’ Party Building Force Point,” *Qiushi*, June 16, 2016. http://www.qstheory.cn/zhuanqu/bk/jx/2016-06/16/c_1119055371.htm; Lucy Hornby, “China Rows Back on State-Sector Reforms,” *Financial Times*, June 14, 2016. <http://www.ft.com/intl/cms/s/0/92e52600-31f7-11e6-ad39-3fee5ffe5b5b.html#axzz4BTMEOTl3>.

⁵⁶ People’s Republic of China, *13th Five-Year Plan on National Economic and Social Development*, March 17, 2016. Staff translation. http://www.gov.cn/xinwen/2016-03/17/content_5054992.htm.

⁵⁷ Xinhua, “China Urges SOE Modernization through Mixed Ownership Reform,” September 24, 2015. http://english.gov.cn/policies/latest_releases/2015/09/24/content_281475197422388.htm.

⁵⁸ Curtis Milhaupt and Wentong Zheng, “Why Mixed-Ownership Reforms Cannot Fix China’s State Sector,” *Paulson Policy Memorandum*, January 2016, 5.

⁵⁹ David Keohane, “SOE You Think You Can Reform? Mixed-Ownership Edition,” *FT Alphaville* (*Financial Times* blog), September 28, 2015. <http://ftalphaville.ft.com/2015/09/28/2140985/soe-you-think-you-can-reform-mixed-ownership-edition/>.

⁶⁰ Sharmin Mossavar-Rohmani et al., “Walled In: China’s Great Dilemma,” *Goldman Sachs*, January 2016, 28. <http://www.goldmansachs.com/what-we-do/investment-management/private-wealth-management/intellectual-capital/isg-china-insight-2016.pdf>.

⁶¹ David Keohane, “SOE You Think You Can Reform? Mixed-Ownership Edition,” *FT Alphaville* (*Financial Times* blog), September 28, 2015. <http://ftalphaville.ft.com/2015/09/28/2140985/soe-you-think-you-can-reform-mixed-ownership-edition/>.

⁶² Sharmin Mossavar-Rohmani et al., “Walled In: China’s Great Dilemma,” *Goldman Sachs*, January 2016, 28. <http://www.goldmansachs.com/what-we-do/investment-management/private-wealth-management/intellectual-capital/isg-china-insight-2016.pdf>.

Categorization of SOEs: The September 2015 guidelines outline a system for pursuing reforms according to new SOE classifications. Under the plans, SOEs will be categorized as either “commercial” or “public,” with commercial SOEs focusing on seeking profits and opening to private investment (although the state will retain the controlling share), while public SOEs focus on public welfare or national security and remain entirely government owned.⁶³ Public SOE reforms will prioritize controlling costs, maintaining the quality of goods and services, and ensuring the stability and efficiency of operations, whereas commercial SOE reform will prioritize market competitiveness and economic value added.⁶⁴ Since announcing the reforms in September 2015, Beijing has not produced plans detailing which SOEs will be classified as commercial and which will be public.⁶⁵

Consolidation of SOEs: The recent reform guidelines announced by Beijing echo earlier directives to consolidate SOEs into globally competitive companies. Beijing has intermittently pursued a policy of consolidation since the 1990s, when then president Jiang Zemin sought to reduce SOE losses by privatizing or shuttering small state-owned companies while increasing the government’s control over larger and more profitable businesses.⁶⁶ Most recently, SASAC in 2015 announced plans to reduce the number of SOEs from around 110 to 40 through mergers and acquisitions.⁶⁷ The principal aim of consolidating and merging SOEs is to inject capital via minimal selling of shares and increasing total assets while retaining majority state control.⁶⁸ Although the September 2015 guidelines did not specifically address reforms to subcentral SOEs, which account for a majority of the country’s 150,000 SOEs, subsequent statements revealed policies to reduce overcapacity and pollution by closing down subcentral SOEs and announced plans to lay off five to six million state workers in the steel and coal industries.⁶⁹ To date, however, there has been little-to-no progress in reducing overcapacity, and indeed there have been some capacity increases.⁷⁰

⁶³ Xinhua, “China Focus: China Issues Guideline to Deepen SOE Reforms,” September 13, 2015.

http://news.xinhuanet.com/english/2015-09/13/c_134620127.htm; Xinhua, “PRC: Full Text of CPC Central Committee Document on Deepening State-Owned Enterprise Reform (Part 1),” September 13, 2015; Xinhua, “PRC: Full Text of CPC Central Committee Document on Deepening State-Owned Enterprise Reform (Part 2),” September 13, 2015.

⁶⁴ Wendy Leutert, “Challenges Ahead in China’s Reform of State-Owned Enterprises,” *Asia Policy* 21 (January 2016): 85.

⁶⁵ Tian Chen et al., “Jockeying Begins as China’s State Firms Brace for Shakeup,” *Bloomberg News*, February 28, 2016. <http://www.bloomberg.com/news/articles/2016-02-28/as-state-firms-brace-for-shakeup-china-s-great-jockeying-begins>.

⁶⁶ Salvatore Babones and I. Stone, “The Costs of Reform,” *Foreign Affairs*, March 24, 2016. <https://www.foreignaffairs.com/articles/china/2016-03-24/costs-reform>.

⁶⁷ China Daily, “China to Reduce Number of Central SOEs to 40,” April 27, 2015. http://china.org.cn/business/2015-04/27/content_35429294.htm.

⁶⁸ Lucy Hornby, “Sinopec’s Capital Raising Highlights Paradox of China’s SOEs,” *Financial Times*, March 19, 2014. <http://www.ft.com/intl/cms/s/0/15413c2a-af27-11e3-bea5-00144feab7de.html#axzz2x1hqfPVD>.

⁶⁹ Chinese University of Hong Kong, “China’s State-Owned Enterprises Reform: Will It Work?” January 5, 2016. <https://cbkcuhk.wordpress.com/2016/01/05/china-state-owned-enterprises-reform-will-this-time-work/>; Benjamin Kang Lim, Matthew Miller, and David Stanway, “Exclusive: China to Lay off Five to Six Million Workers, Earmarks at Least \$23 Billion,” Reuters, March 3, 2016. <http://www.reuters.com/article/us-china-economy-layoffs-exclusive-idUSKCN0W33DS>.

⁷⁰ Duke University Center on Globalization, Governance, and Competitiveness, “Overcapacity in Steel China’s Role in a Global Problem,” September 2016, 12. http://www.americanmanufacturing.org/page/-/uploads/resources/OvercapacityReport2016_R3.pdf.

Increased dividends: Although the Chinese government is entitled to all SOE profits, it has historically allowed SOEs to retain nearly all of their profits—another instance of the state providing SOEs with preferential treatment.⁷¹ In 2010, for example, central SOE profits totaled around \$169 billion, only 3.8 percent of which was paid to the government through taxes and dividends, and which was all recycled back to SOEs rather than contributing to the state budget.⁷² Although SOEs pay taxes, the extent of these payments is often overstated, with reported SOE taxes consisting mostly of remittances of indirect taxes (such as the value-added tax and the excise tax) that put economic burden on consumers, not SOEs.⁷³ To increase SOE payments to the state, dividend rates for central SOEs were set between 0 and 10 percent in 2007, and four years later were increased to between 5 and 15 percent.⁷⁴ According to the most recent guidelines, SOEs will be required to pay a 30 percent dividend to the central government by 2020, with an increasing contribution each subsequent year.⁷⁵ However, companies will still be able to adjust their reported profits by shifting them to subsidiaries or adjusting how investments are accounted for to suppress the portion of profits subject to dividend payments.⁷⁶

State asset management: The government is establishing state investment and operation companies to supervise and manage state assets on behalf of the government—an approach known as the Temasek model.^{77 78} For example, in August 2016, Beijing launched a \$30 billion venture capital fund that will selectively invest in the country's industrial sector, seeking to increase efficiency and upgrade technologies in the sector.⁷⁹ In effect, this policy shifts the central SASAC's function from asset management to regulating state assets on behalf of the government.⁸⁰ However, Dr. Lardy remains uncertain that Beijing

⁷¹ Curtis Milhaupt and Wentong Zheng, "Why Mixed-Ownership Reforms Cannot Fix China's State Sector," *Paulson Policy Memorandum*, January 2016, 7.

⁷² Wei Cui, "Taxation of State Owned Enterprises: A Review of Empirical Evidence from China," in Benjamin Liebman and Curtis Milhaupt, *Chinese State Capitalism and Institutional Change: Domestic and Global Implications*, Oxford University Press, 2015, 13–14.

⁷³ Wei Cui, "Taxation of State Owned Enterprises: A Review of Empirical Evidence from China," in Benjamin Liebman and Curtis Milhaupt, *Chinese State Capitalism and Institutional Change: Domestic and Global Implications*, Oxford University Press, 2015, 13–14.

⁷⁴ Curtis Milhaupt and Wentong Zheng, "Why Mixed-Ownership Reforms Cannot Fix China's State Sector," *Paulson Policy Memorandum*, January 2016, 7.

⁷⁵ Curtis Milhaupt and Wentong Zheng, "Why Mixed-Ownership Reforms Cannot Fix China's State Sector," *Paulson Policy Memorandum*, January 2016, 7.

⁷⁶ European Chamber of Commerce in China, "Overcapacity in China: An Impediment to the Party's Reform Agenda," February 2016, 9.

⁷⁷ **FOOTNOTE:** Temasek, a Singaporean SOE holding company, was founded in 1974 when it inherited 35 companies from the finance ministries. Today, Temasek's holdings have multiplied and diversified, with only 30 percent remaining in Singapore itself. Its domestic holdings are concentrated in "government-linked companies," allowing the state to maintain ownership without interfering in firms' profit-driven management. *Economist*, "From SOE to GLC," November 23, 2013. <http://www.economist.com/news/finance-and-economics/21590562-chinas-rulers-look-singapore-tips-portfolio-management-soe-glc>.

⁷⁸ Tao Wang and Ning Zhang, "Something Positive from the SOE Reform Plan," *UBS Global Research*, September 21, 2015. <https://neo.ubs.com/shared/d1mAD17Obzusll/>.

⁷⁹ Don Weinland, "China Launches \$30bn Venture Fund to Boost Industrial Technology," *Financial Times*, August 18, 2016. <https://www.ft.com/content/fb06343e-6520-11e6-8310-ecf0bddad227>.

⁸⁰ Wendy Leutert, "Challenges Ahead in China's Reform of State-Owned Enterprises," *Asia Policy* 21 (January 2016): 90.

will fully embrace the new regulatory model, saying, “SASAC has a penchant for intervention in firm decision making that is the opposite of the Temasek model.”⁸¹

Employee Stock Ownership Plan: SASAC has announced plans to pilot an employee stock ownership program, which will allow employees of select SOEs to buy company stocks.⁸² Beijing hopes the plan will incentivize SOE employees to work to improve company competitiveness and stimulate productivity, particularly in innovation- and technology-driven sectors.⁸³ However, the SOE equity pilot program will be restricted to small, nonstrategic SOEs, limiting its impact on strategic, high-tech industries.⁸⁴ Additionally, the pilot mandates the state maintain at least a 34 percent ownership in the SOEs’ total equity while employees’ total share cannot exceed 30 percent, further illustrating that maintaining state control remains the central tenet of all SOE reforms.⁸⁵

SOE Accountability System: In August 2016, the State Council has announced guidelines to create an SOE accountability system to strengthen supervision of state firms’ operations and investments. The accountability system, which will be set up by 2017, seeks to increase the value of SOE assets, strengthen supervision and management, and prevent losses. The new system will impose stricter penalties on SOE managers, holding them directly responsible for state losses if they incorrectly perform their duties. The guidelines also urge SOEs to clarify manager responsibilities, standardize decision making, and establish risk awareness.⁸⁶

State Control in Strategic Sectors—Public and Private

Under Chinese-style state capitalism, government ownership is not the only indicator of the degree and scope of government control. Instead, the government’s combined use of markets and state intervention varies depending on the perceived strategic value—be it economic or political—of a sector (see Table 1).⁸⁷ In her testimony to the Commission, Roselyn Hsueh, assistant professor of political science and Asian

⁸¹ Bloomberg News, “China State Company Research Head Eyes Temasek Model, Not Russia,” October 1, 2015.

<http://www.bloomberg.com/news/articles/2015-10-01/china-state-company-research-head-eyes-temasek-model-not-russia>.

⁸² State-Owned Assets Supervision and Administration Commission’s Bureau of Enterprise Reform, “Regarding the Distribution of the ‘SOE Notification to Carry out Employee Stock Ownership Plan,’” August 18, 2016. Staff translation.
<http://www.sasac.gov.cn/n85881/n85901/c2414491/content.html>.

⁸³ Xinhua, “News Analysis: China Pilots Plan for SOE Employee Stock Ownership,” August 18, 2016.
http://news.xinhuanet.com/english/2016-08/18/c_135612199.htm.

⁸⁴ State-Owned Assets Supervision and Administration Commission’s Bureau of Enterprise Reform, “Regarding the Distribution of the ‘SOE Notification to Carry out Employee Stock Ownership Plan,’” August 18, 2016. Staff translation.
<http://www.sasac.gov.cn/n85881/n85901/c2414491/content.html>.

⁸⁵ State-Owned Assets Supervision and Administration Commission’s Bureau of Enterprise Reform, “Regarding the Distribution of the ‘SOE Notification to Carry out Employee Stock Ownership Plan,’” August 18, 2016. Staff translation.
<http://www.sasac.gov.cn/n85881/n85901/c2414491/content.html>.

⁸⁶ State Council of the People’s Republic of China, “China to Set up Accountability System for SOEs,” August 23, 2016.
http://english.gov.cn/policies/latest_releases/2016/08/23/content_281475424065504.htm.

⁸⁷ Roselyn Hsueh, “State Capitalism, Chinese-Style: Strategic Value of Sectors, Sectoral Characteristics, and Globalization,” *Governance* 29: 1 (January 2016): 8586.

studies at Temple University, emphasized that Chinese-style capitalism requires market coordination, which “combines competition with deliberate regulation to achieve industrial modernization and economic and security goals.”⁸⁸ The higher the degree and the 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, such as restricting competition in strategic sectors.⁸⁹ As such, the Chinese government’s influence over private companies in strategic sectors is often underestimated. Wentong Zheng, an associate professor at the University of Florida’s Levin School of Law, stated in his testimony before the Commission 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.”⁹⁰ In this ecosystem, public and private managers alike are incentivized to foster close ties with the government, relying on government ties for the financial and regulatory benefits essential for operating a successful business in China.⁹¹

Table 1: Strategic Sectors Identified in China’s State Planning

Made in China 2025 (2015)	Strategic Emerging Industries (2010)	Strategic Industries (2006)	Heavyweight Industries (2006)
(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.

⁸⁸ U.S.-China Economic and Security Review Commission, *Hearing on China’s Shifting Economic Realities and Implications for the United States*, oral testimony of Roselyn Hsueh, February 24, 2016.

⁸⁹ Roselyn Hsueh, “State Capitalism, Chinese-Style: Strategic Value of Sectors, Sectoral Characteristics, and Globalization,” *Governance* 29: 1 (January 2016): 89.

⁹⁰ U.S.-China Economic and Security Review Commission, *Hearing on China’s Shifting Economic Realities and Implications for the United States*, oral testimony of Wentong Zheng, February 24, 2016.

⁹¹ U.S.-China Economic and Security Review Commission, *Hearing on China’s Shifting Economic Realities and Implications for the United States*, oral testimony of Wentong Zheng, February 24, 2016.

In a 2016 report, Professor Hsueh offers case studies examining market governance in the telecommunications and textiles industries, two areas of diverging strategic importance to the Chinese government:

- *Telecommunications (strategic)*: As a strategic sector, telecommunications' perceived value lies in the industry's importance to the government's goals of advancing and controlling China's technology infrastructure, disseminating and controlling information, and protecting national security. The sector is subject to heavy central-level control, and industry actors are commonly state owned or state controlled. Sector-specific rules on pricing, market entry and exit, business scope, technical standards, and ownership structures maximize the benefits of state control and minimize opportunities for foreign companies—for example, by 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.⁹²
- *Textiles (nonstrategic)*: Following the first wave of economic liberalization and privatization in China, the textile industry was deemed a nonstrategic industry, having few applications for national security and low contribution to the national technology base. As a result, the sector experiences a decentralized market stakeholder pattern, where market coordination is looser and ownership is dominated by quasi-state and private firms. China introduced competition in textiles in the 1980s and devolved market coordination to local governments and commerce bureaus by the early 1990s. During this period, the central government undertook forced closures of failing state-owned textiles factories, mergers of weak and strong companies, and industrial upgrading across subsectors, allowing local governments to restructure local firms and industries in accordance with their own agendas.⁹³ In the 2000s, in compliance with World Trade Organization (WTO) commitments, China liberalized foreign participation in textile retail and distribution, while the Ministry of Commerce delegated administration of the industry to local commerce bureaus and business associations.⁹⁴

According to Professor Hsueh, patterns of state control over industries of divergent strategic importance, as demonstrated by the two aforementioned sectors, display China's adoption of "bifurcated capitalism." This bifurcated capitalism approach increases government authority and capacity to control assets perceived as strategic to the state and to structure market entry and sectoral developments—regardless of whether the

⁹² Roselyn Hsueh, "State Capitalism, Chinese-Style: Strategic Value of Sectors, Sectoral Characteristics, and Globalization," *Governance* 29: 1 (January 2016): 94.

⁹³ Roselyn Hsueh, "State Capitalism, Chinese-Style: Strategic Value of Sectors, Sectoral Characteristics, and Globalization," *Governance* 29: 1 (January 2016): 96.

⁹⁴ Roselyn Hsueh, "State Capitalism, Chinese-Style: Strategic Value of Sectors, Sectoral Characteristics, and Globalization," *Governance* 29: 1 (January 2016): 97.

assets are private or state owned.⁹⁵ These market governance patterns are manifested in other sectors across China's economy as foreign investment limits and regulatory actions to influence market actors, among other measures. By restricting investment primarily in strategic sectors, the state is able to maximize the gains and minimize the costs of China's global economic integration.⁹⁶ The U.S. State Department's 2016 Investment Climate Statement notes that China's legal system is also biased against foreign investors:

*Foreign investors [in China] have expressed concern that the legal system allows regulators significant discretion to adapt decisions to changing circumstances, which results in an unpredictable business climate and rulings that can appear arbitrary or discriminatory. Generally, unlike the United States, the legal system is designed to serve state and Communist Party interests, and as such, does not consistently protect individual rights or effectively resolve disputes.*⁹⁷

The Committee on Foreign Investment in the United States (CFIUS) scrutinizes foreign SOEs and government entities engaging in economic activity abroad more closely than private businesses, subjecting all transactions involving a foreign government to a mandatory 45-day investigation after the first-round 30-day investigation is complete.⁹⁸ Nonetheless, both private and public Chinese entities present significant risks to U.S. economic and national security, as the degree of state ownership does not necessarily reflect a business' strategic importance. During the Commission's June 2016 trip to Asia, Chinese officials told the Commission that the Chinese government does not make direct financial payments to private firms.⁹⁹ However, to retain control of strategic industries, the state can exert other methods of "control" over private companies, including through direct ownership, indirect ownership via a controlling interest in a "legal person" entity,¹⁰⁰ preferential lending by a state bank, or board member appointments,¹⁰¹ or forcing an agreement among shareholders.¹⁰² Several policy memoranda published by the Paulson Institute highlight the channels through which the Chinese government influences or controls private firms despite its lack of majority ownership, including:

⁹⁵ U.S.-China Economic and Security Review Commission, *Hearing on China's Shifting Economic Realities and Implications for the United States*, oral testimony of Roselyn Hsueh, February 24, 2016.

⁹⁶ Roselyn Hsueh, "State Capitalism, Chinese-Style: Strategic Value of Sectors, Sectoral Characteristics, and Globalization," *Governance* 29: 1 (January 2016): 98.

⁹⁷ U.S. Department of State, *2016 Investment Climate Report—China*, May 2016.
<http://www.state.gov/e/eb/rls/othr/ics/investmentclimatestatements/index.htm?year=2016&dliid=254271>.

⁹⁸ Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons for 2008 § 800, Pub. L. No. 102-484, codified at 31 C.F.R. § 800. <https://www.treasury.gov/resource-center/international/foreign-investment/Documents/Pre-FINSA-Regs-31CFR800.pdf>.

⁹⁹ Chinese officials, meeting with Commission, Beijing, China, June 24, 2016.

¹⁰⁰ **FOOTNOTE:** 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.

¹⁰¹ U.S.-China Economic and Security Review Commission, *Hearing on China's Shifting Economic Realities and Implications for the United States*, oral testimony of Wentong Zheng, February 24, 2016.

¹⁰² Curtis Milhaupt and Wentong Zheng, "Why Mixed-Ownership Reforms Cannot Fix China's State Sector," *Paulson Policy Memorandum*, January 2016, 5, 11.

- *Political connections:* In their research, Professor Zheng and Curtis Milhaupt, a professor at Columbia Law School, found 95 out of the top 100 private Chinese firms by revenue and eight out of the top ten Internet firms by revenue were founded or are controlled by a current or former member of a central or local political organization such as the People's Congresses and People's Political Consultative Conferences.¹⁰³ These connections are integral to a private firm's success, creating and reinforcing important networks to top banks, other leading SOEs, and government regulators.¹⁰⁴
- *Financial support:* Private firms often rely heavily on government subsidies to increase profit margins. In Professor Zheng's testimony to the Commission, he explained that private companies "have to have the help of the state in order to prosper or even survive."¹⁰⁵ Huawei, for example, is a privately held firm but receives major funding from state banks due to its status as a "national champion."¹⁰⁶ ¹⁰⁷ Privately owned Geely Automobile is another example of a company that benefitted from state support, receiving \$141 million in 2011 from government subsidies, over half of its net profits for the year.¹⁰⁸ Another private automobile manufacturer, BYD Co., has also benefitted from state support, receiving \$108 million in 2013 from local and central government subsidies, nearly 130 percent of its net profits for the year.¹⁰⁹
- *Extralegal control:* Private companies are subjected to largely undefined regulations that dilute the rights of corporate owners. Take, for instance, China's state-run industry associations, which were created in the 1990s amid mounting pressure for the government to separate its regulatory power from its business activities. State-run industry associations¹¹⁰ were meant to provide industrial coordination and private regulation, but they have become quasi-governmental entities: created and staffed by former government officials from defunct ministries, they supervise and coordinate the

¹⁰³ Curtis Milhaupt and Wentong Zheng, "Why Mixed-Ownership Reforms Cannot Fix China's State Sector," *Paulson Policy Memorandum*, January 2016, 10.

¹⁰⁴ Curtis Milhaupt and Wentong Zheng, "Why Mixed-Ownership Reforms Cannot Fix China's State Sector," *Paulson Policy Memorandum*, January 2016, 11.

¹⁰⁵ U.S.-China Economic and Security Review Commission, *Hearing on China's Shifting Economic Realities and Implications for the United States*, oral testimony of Wentong Zheng, February 24, 2016.

¹⁰⁶ **FOOTNOTE:** Chinese "national champions" are industrial giants capable of competing globally. They are supported by government policies and expected to advance the interests of the state. Derek Scissors, "Deng Undone: The Costs of Halting Market Reform in China," *Foreign Affairs*, May/June 2009. <https://www.foreignaffairs.com/articles/china/2009-05-01/deng-undone-0>.

¹⁰⁷ Curtis Milhaupt and Wentong Zheng, "Why Mixed-Ownership Reforms Cannot Fix China's State Sector," *Paulson Policy Memorandum*, January 2016, 11.

¹⁰⁸ Benjamin L. Liebman and Curtis Milhaupt, eds., *Regulating the Visible Hand? The Institutional Implications of Chinese State Capitalism*, Oxford University Press, October 2015, 195.

¹⁰⁹ Rose Yu, Colum Murphy, and Mike Ramsey, "Subsidies Stoke China's Domestic Car Makers," *Wall Street Journal*, May 23, 2014. <http://www.wsj.com/articles/SB10001424052702304422704579571863054872766>.

¹¹⁰ **FOOTNOTE:** One of the most prominent state-run industry associations in China is the China Petroleum and Chemical Industry Association, which oversees 70 percent of the operations in China's petroleum and chemical industries. China Petroleum and Chemical Industry Federation, "About Us." <http://www.cpcia.org.cn/English/about.asp>.

activities of firms whose ministries have been disbanded.¹¹¹ Compulsory participation in these state-led industrial restructuring efforts, along with other forms of pressure from regulators to comply with government-favored policies, contribute to the state's extralegal control over private enterprises.¹¹²

Simultaneously, SOEs in nonstrategic sectors are not necessarily beholden to direct government control as their shareholding structures may suggest.¹¹³ The state frequently reverts to its role as regulator, rather than owner, to influence nonstrategic SOE behavior but not dictate its activities, suggesting Beijing does not view corporate control as its most effective means of influencing SOEs in nonstrategic sectors.¹¹⁴ As a result, gradual privatization has increased competition and profitability in nonstrategic sectors of the economy; between 1996 and 2002, the gross profits of China's textile industry grew 487 percent as the government reduced its role and increased privatization in the sector.¹¹⁵

Overcapacity and Global Markets

China's overcapacity, or the overproduction of a given product, has become a global problem threatening the vitality of industrial producers around the world.¹¹⁶ The Chinese government is guilty of stoking the current global commodity glut, with Beijing's preferential treatment of industrial producers distorting markets for products like steel, coal, and aluminum. These industries receive critical financial support from state banks, allowing them to overproduce even as global demand has fallen in recent years.¹¹⁷ During the Commission's 2016 trip to China, Chinese officials told the Commission that cutting capacity is politically difficult for the Chinese government because it risks creating a surge in unemployment and a sharp deceleration in growth.¹¹⁸ As a result, China has only made small production cuts over the last year,¹¹⁹

¹¹¹ Curtis Milhaupt and Wentong Zheng, "Why Mixed-Ownership Reforms Cannot Fix China's State Sector," *Paulson Policy Memorandum*, January 2016, 12.

¹¹² Curtis Milhaupt and Wentong Zheng, "Why Mixed-Ownership Reforms Cannot Fix China's State Sector," *Paulson Policy Memorandum*, January 2016, 12.

¹¹³ U.S.-China Economic and Security Review Commission, *Hearing on China's Shifting Economic Realities and Implications for the United States*, oral testimony of Roselyn Hsueh, February 24, 2016.

¹¹⁴ Curtis Milhaupt and Wentong Zheng, "Why Mixed-Ownership Reforms Cannot Fix China's State Sector," *Paulson Policy Memorandum*, January 2016, 9.

¹¹⁵ Larry D. Qiu, "China's Textile and Clothing Industry," *Hong Kong University of Science and Technology*, 2005, 10. http://s3.amazonaws.com/zanran_storage/www.bm.ust.hk/ContentPages/18112599.pdf.

¹¹⁶ European Chamber of Commerce in China, "Overcapacity in China: An Impediment to the Party's Reform Agenda," February 2016, 2.

¹¹⁷ U.S.-China Economic and Security Review Commission, *Hearing on China's Shifting Economic Realities and Implications for the United States*, oral testimony of Terrence Stewart, February 24, 2016.

¹¹⁸ Chinese officials, meeting with Commission, Beijing, China, June 24, 2016; Xinhua, "Cutting Excess Capacity Poses Challenges to China's Economy: UBS," June 11, 2016. http://news.xinhuanet.com/english/2016-06/11/c_135428249.htm.

¹¹⁹ **FOOTNOTE:** During the first eight months of 2016, China reduced its production of crude steel by 0.1 percent compared to the same period in 2015. World Steel Association, "August 2016 Crude Steel Production," September 21, 2016. <https://www.worldsteel.org/media-centre/press-releases/2016/August-2016-crude-steel-production2.html>.

allowing global prices to fall further and leaving millions of workers outside China—particularly in the United States and Europe—without jobs.¹²⁰

The primary origin of excess capacity is China's legacy of inefficient industrial policies and imbalanced growth, designed to boost exports, support domestic industries and firms, and undermine foreign competition. While overcapacity initially sustained China's economy through pricing and market advantages, these policies have distorted resource allocation and diverted investments from productive uses, resulting in damaging consequences for China's domestic economy and the global economy at large.¹²¹ The government's economic policies prioritize short-term growth and employment and rely heavily on exports and investment, resulting in a massive expansion of production capacity and, ultimately, an excess of industrial production.¹²²

Other policy directives from Beijing have also contributed to global overcapacity. China's renminbi (RMB) 4 trillion (\$597 billion) stimulus program, implemented in 2008 during the global financial crisis, was largely dedicated to infrastructure projects and protecting heavy industry through an array of subsidies and other fiscal support measures (see Figure 2).¹²³ This stimulus generated a rapid recovery and expansion in upstream sectors such as steel, machinery, and metals.¹²⁴ China's industrial policy, designed to support the development of domestic industries and create national champions, also contributed to overproduction in certain government-targeted industries.¹²⁵ These factors, coupled with a massive demand for construction machinery and building materials amid the country's rapid urbanization,¹²⁶ gave rise to excess capacity in many of China's manufacturing industries.¹²⁷

¹²⁰ U.S.-China Economic and Security Review Commission, *Hearing on China's Shifting Economic Realities and Implications for the United States*, oral testimony of Terrence Stewart, February 24, 2016.

¹²¹ European Chamber of Commerce in China, "Overcapacity in China: An Impediment to the Party's Reform Agenda," February 2016, 2.

¹²² European Chamber of Commerce in China, "Overcapacity in China: An Impediment to the Party's Reform Agenda," February 2016, 2.

¹²³ **FOOTNOTE:** During the 2008–2009 global financial crisis, China implemented a two-year, RMB 4 trillion (\$597 billion) stimulus package—equivalent to 13.3 percent of China's 2008 GDP—largely dedicated to infrastructure construction projects. Wayne M. Morrison, "China and the Global Financial Crisis: Implications for the United States," *Congressional Research Service*, June 3, 2009, 5. <https://www.fas.org/sgp/crs/row/RS22984.pdf>.

¹²⁴ Wayne M. Morrison, "China and the Global Financial Crisis: Implications for the United States," *Congressional Research Service*, June 3, 2009, 5. <https://www.fas.org/sgp/crs/row/RS22984.pdf>.

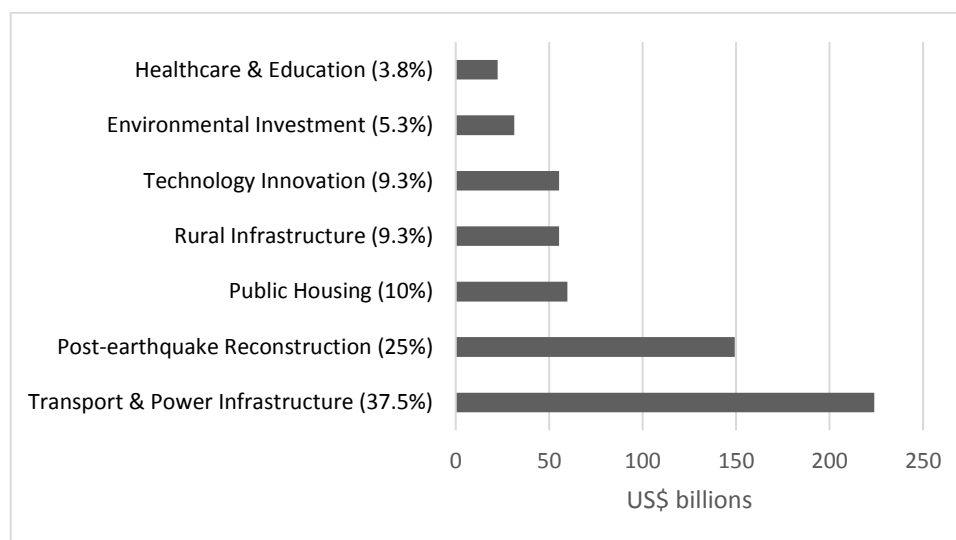
¹²⁵ U.S.-China Economic and Security Review Commission, Chapter 1, Section 2, "Foreign Investment Climate in China," in *2015 Annual Report to Congress*, November 2015, 76–77, 158.

¹²⁶ **FOOTNOTE:** Between 1950 and 2015, the population of urban residents in China grew from 13 percent of the total population to around 55 percent. Karen C. Seto, "What Should We Understand about Urbanization in China?" *Yale Insights* (Yale School of Management blog), November 1, 2013. <http://insights.som.yale.edu/insights/what-should-we-understand-about-urbanization-china>; Li Keqiang, "Report on the Work of the Government" (Fourth Session of the 12th National People's Congress, Beijing, China, March 5, 2016). http://en.nhffc.gov.cn/2016-03/18/c_69571.htm.

¹²⁷ European Chamber of Commerce in China, "Overcapacity in China: Causes, Impacts and Recommendations," 2009, 6.

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Figure 2: Chinese Stimulus Spending by Sector, 2008–2010



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Note: Percentages indicate the percentage of spending on one area compared to the total stimulus package.

Source: Rui Fan, “China’s Excess Capacity: Drivers and Implications,” *Stewart and Stewart*, June 2015, 5.

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The government’s central role in the economy and state-owned financial sector has enabled it to control industrial markets, creating distortions that perpetuate overproduction (for some examples of overcapacity industries in China, see Table 2).¹²⁸ Although it is difficult to estimate the total number of state-owned industrial companies in China, a report on Chinese overcapacity released by the European Chamber of Commerce in February 2016 reveals that “the state controls many” industrial companies, and that “capacity, production, and market share goals are used as the primary benchmarks to assess the performance” of SOEs, not profitability or efficiency.¹²⁹ Beijing also has extensive control over the country’s financial sector, often directing state banks to support state policies at the expense of profit goals.¹³⁰ By directing banks to support industrial growth through direct and indirect measures—including preferential loans, subsidies, and discounted resources for production, which are estimated to lower financing costs 40 to 50 percent below the benchmark lending rate—Beijing props up companies and allows them to remain viable despite selling products well below market prices.¹³¹

¹²⁸ Wendy Leutert, “Challenges Ahead in China’s Reform of State-Owned Enterprises,” *Asia Policy*, Number 21 (January 2016), 88. <http://www.brookings.edu/~media/research/files/articles/2016/02/reform-china-state-owned-enterprises-leutert/wendy-leutert--challenges-ahead-in-chinas-reform-of-stateowned-enterprises.pdf>.

¹²⁹ European Chamber of Commerce in China, “Overcapacity in China: An Impediment to the Party’s Reform Agenda,” February 2016, 14.

¹³⁰ Fitch Ratings, “Fitch: Chinese Banks Struggle to Balance Strategic Roles, Profit Goals,” January 7, 2016. <https://www.fitchratings.com/site/pressrelease?id=997607>.

¹³¹ International Monetary Fund, *The People’s Republic of China: 2016 Article IV Consultation: Selected Issues*, August 2016, 38; Gabriel Wildau, “China’s State-Owned Zombie Economy,” *Financial Times*, February 29, 2016. <http://www.ft.com/intl/cms/s/0/253d7eb0-ca6c-11e5-84df-70594b99fc47.html#axzz4B1BR8Ge3>.

Table 2: Select Chinese Overcapacity Industries

Aluminum	Copper	Paper and Pulp
Chemicals	Cotton	Power Generation Equipment
Cement	Glass	Rubber
Ceramic	Iron	Solar Panels
Coal	Oil Refining	Steel

Source: Various.¹³²

Because the promotion system for government officials ascribes great value to their ability to achieve high growth, local governments are incentivized to promote local economic expansion through investment without considering potential costs.¹³³ As a result, local governments supply productive factors (e.g., land, water, electricity, and bank loans) to inefficient enterprises and industries at below-market prices or with special incentives—such as guarantees for bank loans and tolerating environmental damage—that further distort markets and encourage overinvestment.¹³⁴

Levels of Overcapacity

China's overcapacity problem was staggering in scale as early as the 1990s, when capacity utilization rates in many industrial sectors ranged from 35 to 40 percent, far below the normal capacity utilization rate of around 80 percent.^{135 136} China's WTO accession in 2001 temporarily alleviated the overcapacity challenge by introducing a boost in external demand; as a result, China's overcapacity yielded significant advantages in export competitiveness, and its capacity utilization rates peaked around 90 percent in 2007.¹³⁷ However, the 2008 financial crisis saw global demand plummet, once again unmasking the vulnerabilities of the Chinese government's focus on promoting select industries.¹³⁸

¹³² James T. Areddy, "G-20 Says Industrial Overcapacity Has Put Dent in Global Trade," *Wall Street Journal*, July 10, 2016. <http://www.wsj.com/articles/g-20-says-industrial-overcapacity-has-put-dent-in-global-trade-1468152007>; Brian Spegele and John W. Miller, "China Continues to Prop up Its Ailing Factories, Adding to Global Glut," *Wall Street Journal*, May 9, 2016. <http://www.wsj.com/articles/chinese-exports-surge-amid-overcapacity-at-home-1462746980>; Shuaihua Wallace Cheng, "Overcapacity a Time Bomb for China's Economy," *South China Morning Post*, September 28, 2015. <http://www.scmp.com/comment/insight-opinion/article/1862024/overcapacity-time-bomb-chinas-economy>; and Aegis Europe, "Press Release: China's Industrial Overcapacity Is Destroying Key European Industries, July 14, 2016. <http://www.aegiseurope.eu/news/press-release-chinas-industrial-overcapacity-is-destroying-key-european-industries>.

¹³³ Biliang Hu and Jian Zhuang, "Knowledge Work on Excess Capacity in the People's Republic of China," *Asian Development Bank*, July 2015, 9. <https://www.adb.org/sites/default/files/project-document/161581/knowledge-work-excess-capacity-prc.pdf>.

¹³⁴ Biliang Hu and Jian Zhuang, "Knowledge Work on Excess Capacity in the People's Republic of China," *Asian Development Bank*, July 2015, 9. <https://www.adb.org/sites/default/files/project-document/161581/knowledge-work-excess-capacity-prc.pdf>.

¹³⁵ **FOOTNOTE:** According to the Asian Development Bank, the normal capacity utilization rate in most developed and developing nations is between 79 percent and 83 percent. A rate above 90 percent denotes a capacity shortage, while a rate below 79 percent implies excess capacity. Biliang Hu and Jian Zhuang, "Knowledge Work on Excess Capacity in the People's Republic of China," *Asian Development Bank*, July 2015, 4. <https://www.adb.org/sites/default/files/project-document/161581/knowledge-work-excess-capacity-prc.pdf>.

¹³⁶ European Chamber of Commerce in China, "Overcapacity in China: Causes, Impacts and Recommendations," 2009, 6.

¹³⁷ Janet Hao and Andrew Polk, "Appraising Industrial Overcapacity—the Achilles Heel of Chinese Growth?" *Conference Board China Center for Economics & Business*, September 2015, 4.

¹³⁸ Janet Hao and Andrew Polk, "Appraising Industrial Overcapacity—the Achilles Heel of Chinese Growth?" *Conference Board China Center for Economics & Business*, September 2015, 1.

Official Chinese studies are indicative of the country's growing overcapacity. Of the 39 products investigated in the National Development and Reform Commission's (NDRC) last study of overcapacity in 2013, 21 products had capacity utilization rates lower than 75 percent, indicating overcapacity in those sectors.¹³⁹ The study found tackling excess capacity in "traditional manufacturing industries" such as steel, cement, aluminum, flat glass, and shipbuilding was especially urgent.¹⁴⁰ In a 2014 study (latest available), China's Ministry of Industry and Information Technology identified 15 industries suffering from continued excess capacity.¹⁴¹

Because there are significant gaps in China's official data reporting about capacity utilization, however, overcapacity levels should also be assessed based on other indicators.¹⁴² One observable symptom of Chinese overcapacity is the country's declining Producer Price Index (PPI), which measures the change in prices received by producers for their goods and services over time. Due to downward pressure on industry profits as a result of overcapacity, China's heavy industry PPI has declined 11 percent since 2010, indicating producers were continually receiving lower and lower prices for their products every month through January 2016 (see Figure 3).¹⁴³

¹³⁹ China's National Development and Reform Commission, "Deepening Reform While Maintaining Stability to Promote Restructuring and Development," December 11, 2013. Staff translation. http://tgs.ndrc.gov.cn/jjgg/cwjd/201312/t20131211_569914.html; Janet Hao and Andrew Polk, "Appraising Industrial Overcapacity—the Achilles Heel of Chinese Growth?" *Conference Board China Center for Economics & Business*, September 2015, 5.

¹⁴⁰ **FOOTNOTE:** According to the NDRC study, capacity utilization rates in 2012 for steel, cement, aluminum, flat glass, and shipbuilding were 72 percent, 73.7 percent, 71.9 percent, 73.1 percent, and 75 percent, respectively. China's National Development and Reform Commission, "Deepening Reform While Maintaining Stability to Promote Restructuring and Development," December 11, 2013. Staff translation. http://tgs.ndrc.gov.cn/jjgg/cwjd/201312/t20131211_569914.html.

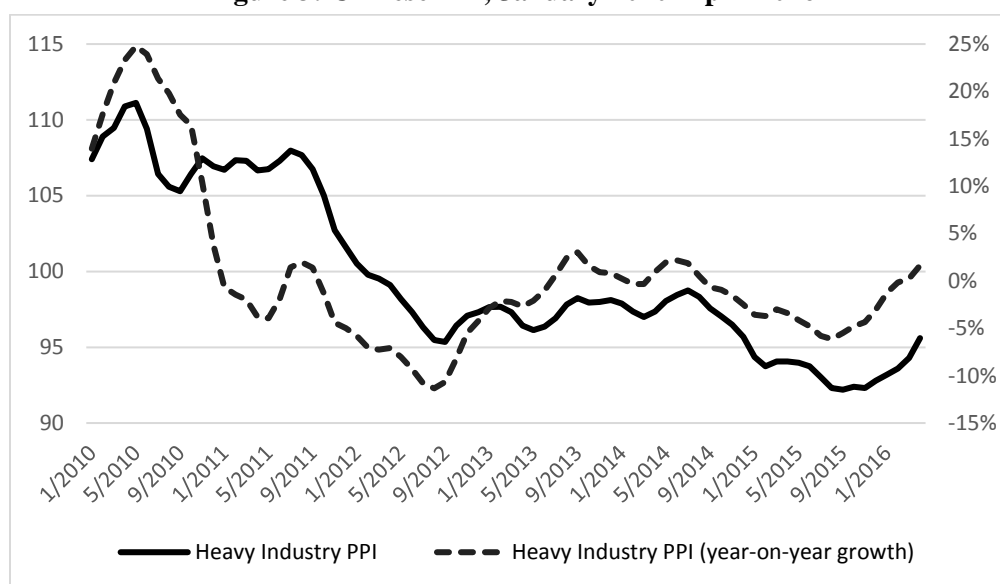
¹⁴¹ **FOOTNOTE:** The industries identified as suffering from overcapacity include iron, steel, coal, ferroalloys, calcium carbonate, aluminum, copper, lead, cement, glass, paper, tannery, dye, chemicals, and lead batteries. China's Ministry of Industry and Information Technology, *2014 List of Industries and Companies with Excess Production Capacity*, July 18, 2014. <http://www.miit.gov.cn/n1146285/n1146352/n3054355/n3057292/n3057295/c3575874/part3575875.pdf>.

¹⁴² Biliang Hu and Jian Zhuang, "Knowledge Work on Excess Capacity in the People's Republic of China," *Asian Development Bank*, July 2015, 5. <https://www.adb.org/sites/default/files/project-document/161581/knowledge-work-excess-capacity-prc.pdf>.

¹⁴³ China's National Bureau of Statistics via CEIC database; European Chamber of Commerce in China, "Overcapacity in China: An Impediment to the Party's Reform Agenda," February 2016, 1.

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Figure 3: Chinese PPI, January 2010–April 2016



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Source: China's National Bureau of Statistics via CEIC database.

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Although domestic prices have declined below production costs, the state continues its unsustainable support for China's unprofitable industrial sectors, propping up unviable companies at the expense of the global market.¹⁴⁴ In China's steel industry, for example, 50 percent of domestic producers are state-owned.¹⁴⁵ Chinese steel producers experienced losses of \$15.5 billion in 2015, a 24-fold increase from 2014.¹⁴⁶ In December 2015, approximately half of China's medium- and large-sized steel firms were unprofitable.¹⁴⁷ Despite the record losses, subsidies and financial support from state banks allowed many of China's largest state-owned steel firms not only to endure losses, but also to continue to increase their production.¹⁴⁸ Meanwhile, China's 2015 utilization rate for steel dropped to 71 percent, down 9 percentage points from 2008 levels.¹⁴⁹ The situation is only expected to worsen as Chinese steel companies continue to expand their production capacity despite lower demand, with global steel production declining 1 percent

¹⁴⁴ Ian Talley, "Why the U.S. Steel Industry Is Molten Hot over China's Trade Practices," *Wall Street Journal*, June 6, 2016. <http://blogs.wsj.com/economics/2016/06/06/why-the-u-s-steel-industry-is-molten-hot-over-chinas-trade-practices/>.

¹⁴⁵ Tom Mitchell and Yuan Yang, "China Rails against Global 'Hype' on Overcapacity," *Financial Times*, June 6, 2016. <http://www.ft.com/intl/cms/s/0/9ee9f1ca-2bca-11e6-a18d-a96ab29e3c95.html#axzz4B1BR8Ge3>.

¹⁴⁶ Xinhua, "Chinese Steel Makers Suffer Heaviest Loss in 2015," April 7, 2016. http://news.xinhuanet.com/english/2016-04/07/c_135258766.htm.

¹⁴⁷ China Iron and Steel Association via CEIC database; Xinhua, "Chinese Steel Makers Suffer Heaviest Loss in 2015," April 7, 2016. http://news.xinhuanet.com/english/2016-04/07/c_135258766.htm.

¹⁴⁸ China Trade Extra, "Senators Warn Malmstrom against Giving China Market Economy Status," June 3, 2016; Duke University Center on Globalization, Governance, and Competitiveness, "Overcapacity in Steel China's Role in a Global Problem," September 2016, 12, 26. http://www.americanmanufacturing.org/page/-/uploads/resources/OvercapacityReport2016_R3.pdf.

¹⁴⁹ European Chamber of Commerce in China, "Overcapacity in China: An Impediment to the Party's Reform Agenda," February 2016, 3; Organization for Economic Co-operation and Development, "Recent Market Developments in the Global Steel Industry," February 2016, 12.

in the first eight months of 2016 compared to the same period in 2015.¹⁵⁰ World prices for hot-rolled coil and rebar, meanwhile, declined by 29 percent and 20 percent year-on-year, respectively, in 2015.¹⁵¹ A brief rebound in Chinese steel prices, up more than 50 percent during the first four months of 2016, led mills to restart or increase production, further contributing to global overcapacity.¹⁵² In August 2016, China produced 68.6 million metric tons of crude steel, a 3 percent increase from August 2015 and more than half of the month's global steel production, even though domestic use continues to decline.¹⁵³

The severity of China's overcapacity has extended into other industries as well, with utilization rates in oil refineries, cement plants, and coal plants dropping 5 percentage points, 9 percentage points, and 11 percentage points, respectively, since 2008 (see Figure 4).¹⁵⁴ Aluminum utilization rates in China have also seen declines, dropping to 76 percent in 2015, a two percentage point decrease from 2008 levels.¹⁵⁵ Of the world's six largest aluminum producers, two—Aluminum Corporation of China Limited (Chalco) and China Power Investment Corp. (CPI)—are Chinese SOEs.¹⁵⁶ Because they receive state funding and financial support, China's aluminum firms also continue to increase production despite declining returns: although 60 percent of China's aluminum producers were unprofitable in 2015, the country produced a record 32 million metric tons of aluminum—a 12 percent increase from 2014.¹⁵⁷

¹⁵⁰ World Steel Association, "August 2016 Crude Steel Production," September 21, 2016. <https://www.worldsteel.org/media-centre/press-releases/2016/August-2016-crude-steel-production2.html>; Yang Ziman, "Losses Rise for Chinese Steelmakers as Demand Continues to Wane," *China Daily*, December 5, 2015. http://www.chinadaily.com.cn/bizchina/2015-12/05/content_22634773.htm. http://www.oecd.org/sti/ind/Background%20document%20No%201_FINAL_Symposium.pdf.

¹⁵¹ Organisation for Economic Co-operation and Development, "Excess Capacity and Structural Adjustment in the Steel Sector," April 18, 2016, 5. http://www.oecd.org/sti/ind/Background%20document%20No%201_FINAL_Symposium.pdf.

¹⁵² Biman Mukherji, "China Steel Pours Out Faster Than Ever," *Wall Street Journal*, July 21, 2016. www.wsj.com/articles/china-steel-pours-out-faster-than-ever-1469105116; Henry Sanderson, "Speculators March into China Commodities," *Financial Times*, April 27, 2016. <https://next.ft.com/content/592c8af4-0b94-11e6-b0f1-61f222853ff3>.

¹⁵³ World Steel Association, "August 2016 Crude Steel Production," September 21, 2016. <https://www.worldsteel.org/media-centre/press-releases/2016/August-2016-crude-steel-production2.html>; Feiwen Rong and Winnie Zhu, "China Steel Export Surge This Year Sign of Weak Local Demand," *Bloomberg News*, May 8, 2016. <http://www.bloomberg.com/news/articles/2016-05-08/steel-exports-from-china-drop-after-rally-in-local-price-demand>.

¹⁵⁴ European Chamber of Commerce in China, "Overcapacity in China: An Impediment to the Party's Reform Agenda," February 2016, 6; U.S. Energy Information Administration, *China*, May 14, 2016, 15; Christine Shearer et al., "Boom and Bust 2016," *Sierra Club*, March 27, 2016; Organisation for Economic Co-operation and Development, "Recent Market Developments in the Global Steel Industry," February 16, 2016, 12; and Nathan Vanderklippe, "China's Huge Cement Industry Latest to Face Massive Cuts," *Globe and Mail*, May 30, 2016.

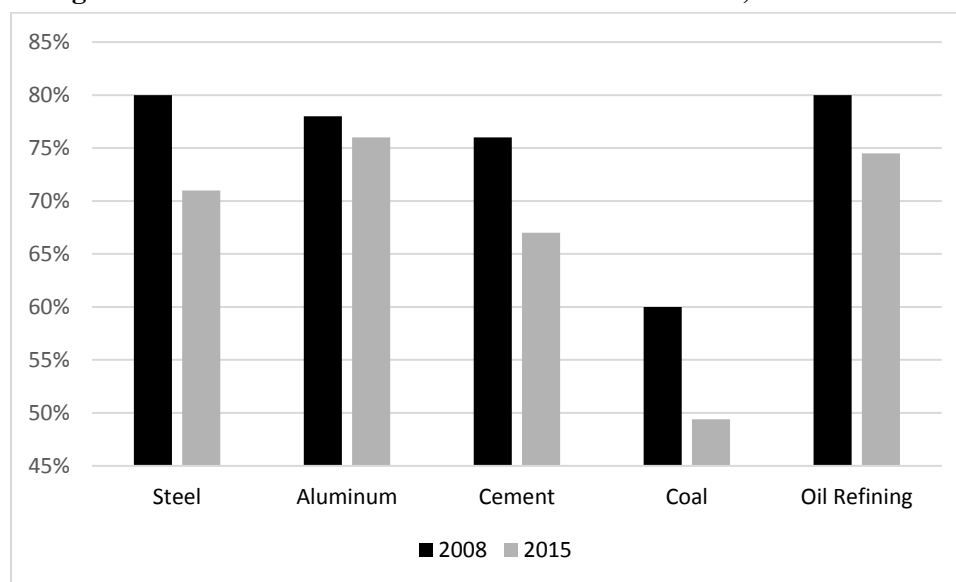
¹⁵⁵ European Chamber of Commerce in China, "Overcapacity in China: An Impediment to the Party's Reform Agenda," February 2016, 3.

¹⁵⁶ RUSAL, "Aluminum Producer." <http://www.rusal.ru/en/aluminium/manufacturers.aspx>.

¹⁵⁷ European Chamber of Commerce in China, "Overcapacity in China: An Impediment to the Party's Reform Agenda," February 2016, 1; World Aluminum, "Primary Aluminum Production." <http://www.world-aluminium.org/statistics/>.

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Figure 4: China's Utilization Rates for Select Industries, 2008 and 2015



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461 Source: European Chamber of Commerce in China, "Overcapacity in China: An Impediment to the Party's Reform Agenda,"
 462 February 2016, 6; U.S. Energy Information Administration, *China*, May 14, 2016, 15; Christine Shearer et al., "Boom and Bust
 463 2016," *Sierra Club*, March 27, 2016; Organisation for Economic Co-operation and Development, "Recent Market Developments
 464 in the Global Steel Industry," February 16, 2016, 12; and Nathan Vanderklippe, "China's Huge Cement Industry Latest to Face
 465 Massive Cuts," *Globe and Mail*, May 30, 2016.

466 U.S. Response to China's Overcapacity

467 The effects of China's rampant industrial overproduction can be seen throughout the global economy, and
 468 have necessitated the exploration of policy responses from the U.S. government on behalf of domestic
 469 industries. In April 2016, for instance, the Office of the U.S. Trade Representative (USTR) and the U.S.
 470 Department of Commerce jointly held a public hearing on the global steel industry and its impact on the
 471 U.S. steel industry and market.¹⁵⁸ At the hearing, U.S. steel industry groups pressed for binding
 472 commitments to cut global net production capacity, particularly from China, and improve enforcement of
 473 antidumping (AD) and countervailing duty (CVD) laws against steel imports flooding the domestic
 474 market.¹⁵⁹ For example, the American Iron and Steel Institute, an association of 19 prominent North

¹⁵⁸ Office of the U.S. Trade Representative, *Request for Comments and Notice of Public Hearing Concerning Policy Recommendations on the Global Steel Industry Situation and Impact on U.S. Steel Industry and Market*, Federal Register, March 4, 2016. <https://www.federalregister.gov/articles/2016/03/04/2016-04857/request-for-comments-and-notice-of-public-hearing-concerning-policy-recommendations-on-the-global>.

¹⁵⁹ Inside U.S. Trade, "Steel Industry Groups Urge Cuts in Overcapacity, Enforcement of Trade Laws," March 31, 2016. <http://insidetrade.com/inside-us-trade/steel-industry-groups-urge-cuts-overcapacity-enforcement-trade-laws>.

475 American steel producers, urged China to cut 337 million to 425 million metric tons of capacity.¹⁶⁰
476 Ultimately, however, no trade remedies or actionable policy plans came out of the hearing.¹⁶¹
477 Chinese officials' continued promises to reduce overcapacity—particularly in the steel industry—have
478 yielded limited production cuts. At a March 2016 meeting of the G20 Finance Ministers and Central Bank
479 Governors in Shanghai, Chinese leaders emphasized their support for cutting capacity.¹⁶² Then, at the 2016
480 U.S.-China Strategic and Economic Dialogue (S&ED) in Beijing, the United States again pushed China to
481 rein in overcapacity—particularly its steel and aluminum production.¹⁶³ However, U.S. Treasury Secretary
482 Jack Lew indicated that conversations at the S&ED failed to bring the United States and China to a
483 “common understanding” on aluminum overcapacity issues and did not produce detailed plans for steel
484 production cuts.¹⁶⁴ A fact sheet released after the discussions revealed the two countries will continue to
485 support international efforts to address global excess capacity and that China is “firmly committed to
486 support international efforts to address steel excess capacity,” but provided no specifics.¹⁶⁵ Most recently,
487 world leaders gathered at the G20 Summit in September 2016 recognized the need to address excess steel
488 capacity, yet they announced no specific plans that would result in immediate reduction of steel
489 production.¹⁶⁶ G20 leaders did, however, call for the formation of a global forum to encourage adjustments
490 in the steel industry and address excess capacity. The forum will report back to the G20 on its progress in
491 2017.¹⁶⁷ In the meantime, China's monthly steel production increased 8.5 percent between January and
492 August 2016 (see Figure 5).

¹⁶⁰ American Iron and Steel Institute, “Our Members.” <http://www.steel.org/about-aisi/members.aspx>; Inside U.S. Trade, “Steel Industry Groups Urge Cuts in Overcapacity, Enforcement of Trade Laws,” March 31, 2016. <http://insidetrade.com/inside-us-trade/steel-industry-groups-urge-cuts-overcapacity-enforcement-trade-laws>.

¹⁶¹ China Trade Extra, “Steel Hearing Offers No Consensus on Remedy Other Than Enforcing Trade Remedy Laws,” April 13, 2016. <http://chinatradeextra.com/daily-news/steel-hearing-offers-no-consensus-remedy-other-enforcing-trade-remedy-laws>.

¹⁶² G20 2016 China, “First G20 Finance Ministers and Central Bank Governors Meeting in 2016 Held in Shanghai,” March 1, 2016. http://www.g20.org/English/China2016/FinanceMeetings/201603/t20160321_2205.html.

¹⁶³ United States Treasury Department, “2016 U.S.-China Strategic and Economic Dialogue Joint U.S.-China Fact Sheet – Economic Track,” June 7, 2016. <https://www.treasury.gov/press-center/press-releases/Pages/jl0484.aspx>.

¹⁶⁴ United States Treasury Department, “Remarks by Treasury Secretary Lew at the 2016 U.S.-China Strategic and Economic Dialogue Closing Ceremony,” June 7, 2016. <https://www.treasury.gov/press-center/press-releases/Pages/jl0483.aspx>.

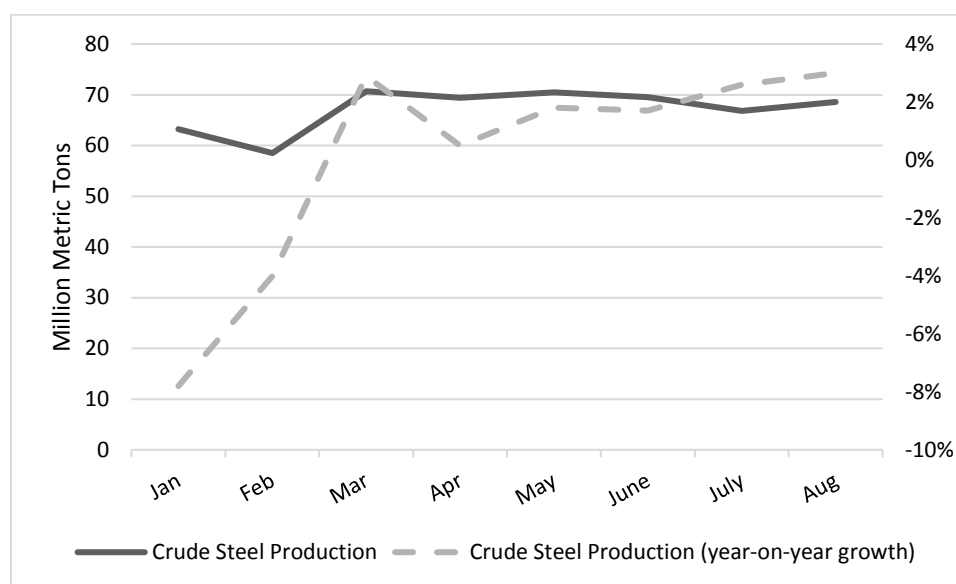
¹⁶⁵ United States Treasury Department, “2016 U.S.-China Strategic and Economic Dialogue U.S. Fact Sheet–Economic Track,” June 7, 2016. <https://www.treasury.gov/press-center/press-releases/Pages/jl0485.aspx>.

¹⁶⁶ White House Office of the Press Secretary, “Fact Sheet: The 2016 G-20 Summit in Hangzhou, China,” September 5, 2016. <https://www.whitehouse.gov/the-press-office/2016/09/05/fact-sheet-2016-g-20-summit-hangzhou-china>.

¹⁶⁷ White House Office of the Press Secretary, “Fact Sheet: The 2016 G-20 Summit in Hangzhou, China,” September 5, 2016. <https://www.whitehouse.gov/the-press-office/2016/09/05/fact-sheet-2016-g-20-summit-hangzhou-china>.

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Figure 5: China's Monthly Crude Steel Production, 2016



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495 Source: World Steel Association, "2016 Press Releases." <https://www.worldsteel.org/media-centre/press-releases.html>.

496 Case Study: Impact of Chinese Overcapacity on U.S. Steel Producers

497 As the leading driver of the current worldwide steel glut, China is widely blamed for triggering a global
 498 steel crisis.¹⁶⁸ From 2004 to 2014, global steel production increased by 57 percent, with China contributing
 499 91 percent of the increase.¹⁶⁹ During the same period, global steel demand increased by only 43.3 percent
 500 between 2005 and 2015.¹⁷⁰ Although China's steel production declined by 2.3 percent year-on-year in 2015,
 501 Chinese factories still produced more than 800 million metric tons of steel—almost eight times more than
 502 the United States produced last year and more than the entire world produced in 1995.¹⁷¹

503 Faced with declining domestic demand due to cutbacks in residential and commercial construction projects,
 504 China's steel industry has relied more heavily on exports, dumping subsidized steel exports into global
 505 markets and putting the U.S. steel industry at risk. China was the world's largest steel exporter in 2015 with
 506 110 million metric tons of steel exports—a 378 percent increase from 2009 levels.¹⁷² China's steel exports
 507 accounted for 13.7 percent of its total steel production in 2015 amid waning domestic demand, up from 4

¹⁶⁸ David Stanway and Ruby Lian, "China Looks Overseas in Bid to Slim Down Bloated Steel Sector," Reuters, April 21, 2016. <http://www.reuters.com/article/us-china-steel-overcapacity-idUSKCN0XI050>.

¹⁶⁹ European Chamber of Commerce in China, "Overcapacity in China: An Impediment to the Party's Reform Agenda," February 2016, 16.

¹⁷⁰ U.S. Department of Commerce International Trade Administration, *Global Steel Report*, July 2016, 9. <http://trade.gov/steel/pdfs/07192016global-monitor-report.pdf>.

¹⁷¹ Salvatore Babones and I. Stone, "The Costs of Reform," *Foreign Affairs*, March 24, 2016. <https://www.foreignaffairs.com/articles/china/2016-03-24/costs-reform>; Nicholas Walter and Soo Jung Kim, "World Crude Steel Output Decreases by -2.8% in 2015," *World Steel Association*, January 25, 2016. <https://www.worldsteel.org/media-centre/press-releases/2016/-World-crude-steel-output-decreases-by--2.8--in-2015.html>.

¹⁷² China Trade Extra, "New Commerce Report Highlights Largest Importing, Exporting Steel Markets," August 2, 2016. <http://chinatradeextra.com/daily-news/new-commerce-report-highlights-largest-importing-exporting-steel-markets>.

percent in 2009.¹⁷³ The volume of Chinese steel exports to the United States grew to nearly 2.2 million metric tons in 2015—a 176.7 percent increase since 2010—bringing China’s share of U.S. steel imports from 3.6 percent in 2010 to 6.1 percent.¹⁷⁴ Although Chinese steel exports to the United States decreased 66 percent in the first seven months of 2016 compared to the same period in 2015, they continue to drive global prices lower and add to the already flooded U.S. steel market.¹⁷⁵ U.S. hot-rolled band prices stood at \$636 per metric ton as of September 12, 2016, down 34.4 percent from March 2011 and 47.1 percent from July 2008.¹⁷⁶

As a result of the global steel glut and declining prices, dominant U.S. steelmakers were under pressure to shutter capacity for much of 2016.¹⁷⁷ Total U.S. steel production declined 10.6 percent year-on-year in 2015, falling from 88.2 million metric tons in 2014 to 78.9 million metric tons in 2015, and U.S. firms’ capacity utilization rates declined 9.5 percent year-on-year to an average of 70.1 percent in 2015.¹⁷⁸ In the first half of 2016, U.S. steel production remained nearly unchanged compared to the same period in 2015, decreasing just 0.2 percent, while utilization rates increased slightly to 71.3 percent in July 2016.¹⁷⁹ U.S. steel producers posted a net loss of \$1.43 billion in the fourth quarter of 2015 and \$233 million in the first quarter of 2016 (see Figure 6).¹⁸⁰ U.S. firms Nucor Corporation and U.S. Steel, which were the world’s thirteenth- and fifteenth-largest steel firms in 2014, respectively, were among the companies struggling to remain competitive.¹⁸¹ U.S. Steel, which dropped to number 24 on the list of world’s largest steel firms in 2015, reported a net loss of \$386 million in the first half of 2016, a 14.9 percent increase from the \$336 million net loss in the first half of 2015, and laid off 1,300 workers in January 2016.¹⁸² Nucor, meanwhile,

¹⁷³ China Trade Extra, “New Commerce Report Highlights Largest Importing, Exporting Steel Markets,” August 2, 2016. <http://chinatradeextra.com/daily-news/new-commerce-report-highlights-largest-importing-exporting-steel-markets>.

¹⁷⁴ **FOOTNOTE:** The largest exporters of steel to the United States are Canada, Brazil, and South Korea, which account for 15 percent, 14 percent, and 13 percent, respectively, of all U.S. steel imports. China is the United States’ seventh-largest source of steel. China Trade Extra, “New Commerce Report Highlights Largest Importing, Exporting Steel Markets,” August 2, 2016. <http://chinatradeextra.com/daily-news/new-commerce-report-highlights-largest-importing-exporting-steel-markets>.

¹⁷⁵ U.S. Department of Commerce International Trade Administration, *Steel Industry Executive Summary: September 2016*, September 2016, 6. <http://enforcement.trade.gov/steel/license/documents/execsumm.pdf>.

¹⁷⁶ SteelBenchmarker, “Price History,” September 12, 2016. <http://steelbenchmarker.com/files/history.pdf>.

¹⁷⁷ Thomas Biesheuvel, “Steelmaking Giant Brought down to Size by China Export Flood,” *Bloomberg Business*, January 18, 2016. <http://www.bloomberg.com/news/articles/2016-01-19/steelmaking-giant-brought-down-to-size-by-chinese-export-tsunami>.

¹⁷⁸ U.S. Department of Commerce International Trade Administration, *Steel Industry Executive Summary: February 2016*, February 2016, 12.

¹⁷⁹ U.S. Department of Commerce International Trade Administration, *Steel Industry Executive Summary: September 2016*, September 2016, 13. <http://enforcement.trade.gov/steel/license/documents/execsumm.pdf>.

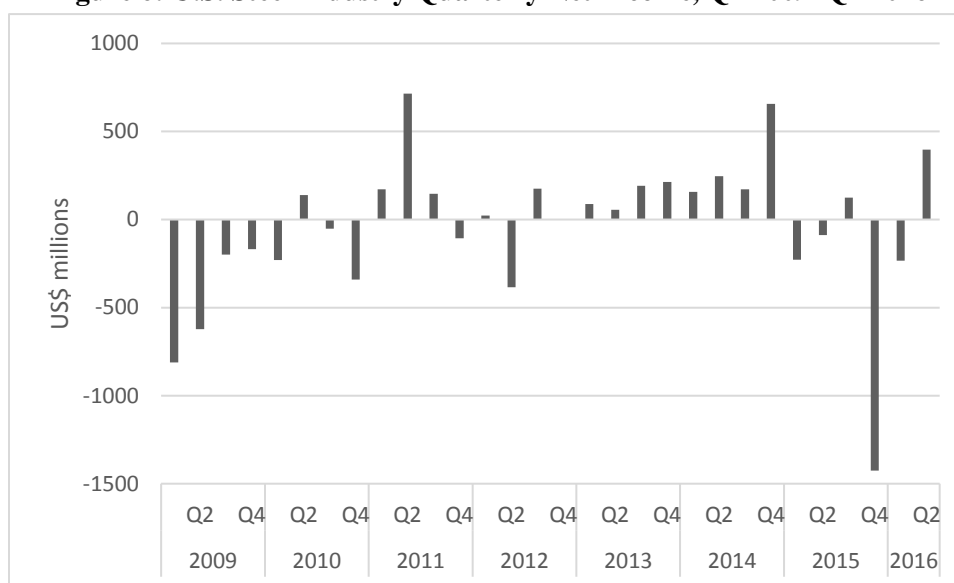
¹⁸⁰ U.S. Department of Commerce International Trade Administration, *Steel Industry Executive Summary: July 2016*, July 2016. <http://enforcement.trade.gov/steel/license/documents/execsumm.pdf>.

¹⁸¹ World Steel Association, “Top Steel-Producing Companies 2014.” <https://www.worldsteel.org/dms/internetDocumentList/downloads/statistics/Extended-listing-2014/document/Extended%20listing%202014.pdf>.

¹⁸² United States Steel Corporation, “United States Steel Corporation Reports Improved 2016 Second Quarter Results and Stronger Cash and Liquidity Position,” July 26, 2016. <http://uss.mediaroom.com/index.php?s=32722&item=137092>; World Steel Association, “Top Steel-Producing Companies,” 2015. <https://www.worldsteel.org/statistics/top-producers.html>;

announced a deterioration of its operating performance in December 2015 as a result of global excess capacity and high imports.¹⁸³ In testimony to the Commission, Nucor CEO John Ferriola referred to overcapacity as a “crisis,” warning that “[the U.S.] steel industry—and the more than one million jobs it supports—will continue to disappear” if China’s excess capacity is not removed from the market.¹⁸⁴ According to Leo W. Gerard, international president of the United Steelworkers, in total nearly 19,000 American steelworkers and iron ore miners are facing layoffs as a result of Chinese overcapacity.¹⁸⁵ U.S. steel companies’ profitability has increased notably in recent months, however, with Nucor reporting net profits rose 87 percent in the second quarter of 2016 compared to the same period in 2015, aided by new tariffs imposed by the U.S. government on steel imports.¹⁸⁶

Figure 6: U.S. Steel Industry Quarterly Net Income, Q1 2009–Q2 2016



Note: Data include financials of AK Steel, Carpenter Technology, Commercial Metals Company, Nucor, Steel Dynamics, and U.S. Steel.
 Source: U.S. Department of Commerce International Trade Administration, *Steel Industry Executive Summary: September 2016*, September 2016. <http://enforcement.trade.gov/steel/license/documents/execsumm.pdf>.

Economist, “A Corrosive Climate,” January 30, 2016. <http://www.economist.com/news/business/21689600-overcapacity-has-worsened-woes-already-unprofitable-industry-corrosive-climate>.

¹⁸³ Nucor Corporation, “Nucor Announces Guidance for Its Fourth Quarter Earnings,” December 16, 2015. <http://www.nucor.com/investor/news/?rid=2123050>.

¹⁸⁴ U.S.-China Economic and Security Review Commission, *Hearing on China’s Shifting Economic Realities and Implications for the United States*, written testimony of John Ferriola, February 24, 2016.

¹⁸⁵ United Steelworkers, “USW Confirms USDOC Final Duties on Cold-Rolled Steel,” July 22, 2016.

<http://www.usw.org/news/media-center/releases/2016/usw-confirms-usdoc-final-duties-on-cold-rolled-steel>.

¹⁸⁶ John W. Miller, “Nucor Profit Soars on Lower Costs, Improving Steel Prices,” *Wall Street Journal*, July 21, 2016. <http://www.wsj.com/articles/nucor-profit-soars-on-lower-costs-improving-steel-price-trends-1469111025>.

To offset Chinese companies' unfair practices, the United States began imposing heavy tariffs on some Chinese subsidized industries in March 2007.^{187 188} In June 2016, the U.S. International Trade Commission approved an increase for duties on Chinese cold-rolled steel, which will now reach more than 500 percent—consisting of a 266 percent AD duty and a 266 percent CVD—in response to dumped and subsidized steel from China.¹⁸⁹

Along with reduced profits and mass layoffs at U.S. steel factories, the influx of Chinese steel poses national security risks to the United States. Over the past 30 years, as U.S. steel manufacturing jobs have been eliminated or moved abroad where manufacturing costs are lower, the United States' critically important defense industrial base has been dramatically reduced.¹⁹⁰ According to Aaron Friedberg, a professor of politics and international affairs at Princeton University, a hollowing out of the U.S. industrial base could become disastrous if the United States is unable to prepare for a protracted conflict.¹⁹¹ The Specialty Metals Clause (10 U.S. Code § 2533b) currently prevents products like steel armor plate (a critical component for producing and maintaining ground combat vehicles, ships, and submarines) from being melted abroad and imported for military use.¹⁹² However, Brigadier General John Adams, U.S. Army (Ret.) warns that if the U.S. steel industry is hollowed out, U.S. manufacturers of military equipment and machinery will be forced to import components from China and elsewhere, raising the possibility that products of subpar or compromised quality could endanger U.S. military personnel and limit the country's ability to respond to a military threat.¹⁹³ General Adams notes, "[The United States] cannot sit idly by as [its] most dangerous

¹⁸⁷ **FOOTNOTE:** Under Title VII of the Tariff Act of 1930, a sufficient percentage of U.S. domestic production for a given industry must support a trade case in order for the Department of Commerce to initiate proceedings. However, increasing investment by Chinese state-owned and controlled enterprises in the United States could reach levels that limit the ability of cases to proceed if the domestic subsidiaries choose to oppose action. Tariff Act of 1930, Pub. L. No. 103-465, 1930, codified at 19 U.S.C. § 1677(18).

¹⁸⁸ Parija B. Kavilanz, "U.S. Slaps Tariffs on Chinese Imports," *CNN*, March 30, 2007.

http://money.cnn.com/2007/03/30/news/economy/china_trade/.

¹⁸⁹ U.S. International Trade Commission, *Cold-Rolled Steel Flat Products from China and Japan Injure U.S. Industry*, Says USITC, June 22, 2016. https://www.usitc.gov/press_room/news_release/2016/er062211621.htm; Matthew McMullan, "ITC Okays Tariffs on Steel Imports from China, Japan," *Alliance for American Manufacturing*, June 22, 2016. <http://www.americanmanufacturing.org/blog/entry/itc-okays-tariffs-on-steel-imports-from-china-japan>.

¹⁹⁰ John Adams, "Remaking American Security: Supply Chain Vulnerabilities and National Security Risks across the U.S. Defense Industrial Base," *Alliance for American Manufacturing*, May 2013, ii. https://s.bsd.net/aamweb/main/page/file/af67e3041f357e0fe8_mlbrstc67.pdf.

¹⁹¹ Aaron L. Friedberg, *In the Shadow of the Garrison State*, Princeton University Press, 2000, 223.

¹⁹² John Adams, "Remaking American Security: Supply Chain Vulnerabilities and National Security Risks across the U.S. Defense Industrial Base," *Alliance for American Manufacturing*, May 2013, 25. https://s.bsd.net/aamweb/main/page/file/af67e3041f357e0fe8_mlbrstc67.pdf.

¹⁹³ John Adams, "Remaking American Security: Supply Chain Vulnerabilities and National Security Risks across the U.S. Defense Industrial Base," *Alliance for American Manufacturing*, May 2013, 25. https://s.bsd.net/aamweb/main/page/file/af67e3041f357e0fe8_mlbrstc67.pdf; Elizabeth Brotherton-Bunch, "It's Not Just the Economy. Steel Imports Also Threaten Our National Security," *Alliance for American Manufacturing*, April 15, 2016. <http://www.americanmanufacturing.org/blog/entry/its-not-just-the-economy.-chinas-steel-imports-also-threaten-our-national-s>.

strategic competitors rob [it] of the capability that ensure [its] weapons and equipment have a reliable source of steel for the future.”¹⁹⁴

Chinese Policy Responses

Beijing has repeatedly stated its commitment to eliminating excess capacity, yet progress has been extremely slow—and in most cases nonexistent.¹⁹⁵ In part, the government’s failure to correct longstanding imbalances is the result of entrenched government interests and fears of domestic unrest.¹⁹⁶ Efforts to consolidate industries and eliminate excess capacity necessitate closing weak firms, laying off employees, and restructuring debt—actions that inherently cause political, economic, and social instability.¹⁹⁷ As a result, the Chinese government has been unwilling to implement meaningful consolidation and restructuring reforms to reduce excess capacity.¹⁹⁸

Over the past five years, China has unveiled numerous policy directives aimed at reducing overcapacity, yet there have been few real breakthroughs.¹⁹⁹ In 2010, the State Council issued guidelines and targets for eliminating excess capacity across several different industries, but at the end of 2012, capacity utilization rates in all those industries, including steel, measured far below normal levels, indicating severe overcapacity.²⁰⁰ In 2013, the State Council issued its “Guidance to Resolve the Serious Overcapacity Problem,” a policy directive acknowledging the extent of China’s overcapacity problem and putting forth recommendations to address the problem, including boosting domestic demand, increasing external demand through a “going global” strategy, promoting SOE consolidation, and strengthening environmental and energy efficiency standards.²⁰¹ Last year, China released its “Steel Industry Adjustment Policy,” aimed at reducing the production of the top ten steel groups to no less than 60 percent of China’s current production by 2025, as well as increasing the steel industry’s capacity utilization rate to 80 percent by 2017.²⁰²

¹⁹⁴ Elizabeth Brotherton-Bunch, “It’s Not Just the Economy. Steel Imports Also Threaten Our National Security,” *Alliance for American Manufacturing*, April 15, 2016. <http://www.americanmanufacturing.org/blog/entry/its-not-just-the-economy.-chinas-steel-imports-also-threaten-our-national-s>.

¹⁹⁵ Caixin, “Time for Officials to Make Hard Reform Choices,” December 23, 2014. <http://english.caixin.com/2015-12-23/100891812.html>.

¹⁹⁶ Barry Naughton, “Two Trains Running: Supply-Side Reform, SOE Reform, and the Authoritative Personage,” *China Leadership Monitor* (Summer 2016): 4–7.

¹⁹⁷ Janet Hao and Andrew Polk, “Appraising Industrial Overcapacity—the Achilles Heel of Chinese Growth?” *Conference Board China Center for Economics & Business*, September 2015, 2.

¹⁹⁸ Janet Hao and Andrew Polk, “Appraising Industrial Overcapacity—the Achilles Heel of Chinese Growth?” *Conference Board China Center for Economics & Business*, September 2015, 2.

¹⁹⁹ European Chamber of Commerce in China, “Overcapacity in China: An Impediment to the Party’s Reform Agenda,” February 2016, 6.

²⁰⁰ Lingna Yan, “China Issues Guidelines to Cut Overcapacity,” *King & Spalding LLP*, December 2, 2013. <http://www.lexology.com/library/detail.aspx?g=e0b9e41d-cdbd-4187-b0c5-1b316c333a4f>.

²⁰¹ Biliang Hu and Jian Zhuang, “Knowledge Work on Excess Capacity in the People’s Republic of China,” *Asian Development Bank*, July 2015, 4. <https://www.adb.org/sites/default/files/project-document/161581/knowledge-work-excess-capacity-prc.pdf>.

²⁰² Steel Net, “Comments on China’s Steel Industry Adjustment Policy (2015 Revision),” April 20, 2016, 4. https://www.steel.org/~media/Files/AISI/Public%20Policy/Letters/Steel_Industry_Adjustment_Policy_Comments.pdf.

To reach the goals set in the “Steel Industry Adjustment Policy,” China has announced a series of targets for cutting production of building materials, including plans to cut coal and steel production by 10 percent over the next two years.²⁰³ In February 2016, the State Council announced China will reduce annual crude steel capacity by between 100 million and 150 million metric tons by 2020—as much as 13 percent of existing capacity—and eliminate 400,000 jobs from the sector.²⁰⁴ Four months later, the State Council laid out more specifics on capacity reduction, announcing goals for cutting annual crude steel capacity by 45 million metric tons and reduce coal capacity by more than 250 million metric tons in 2016.²⁰⁵ Li Xinchuang, head of the China Metallurgical Industry Planning and Research Institute, also declared plans to close “zombie” companies, which account for around 7.5 percent of China’s industrial businesses and 51 percent of listed steel firms, according to a July 2016 study by China’s Renmin University.²⁰⁶ Most recently, the Ministry of Industry and Information Technology released a draft policy document in August 2016 detailing plans to enhance enforcement of environmental standards in overcapacity sectors, threatening to cut off power and water supplies and demolish production equipment if firms fail to meet environmental and safety standards.²⁰⁷

Nevertheless, some experts worry that China’s steel capacity reduction plans are inadequate. According to Louis Kuijs, head of Asia for Oxford Economics in Hong Kong, “the [Chinese] government’s plans to cut overcapacity seem modest compared to the scale of the problems.”²⁰⁸ Helen Lau, analyst at Argonaut Securities Pty Ltd., said of Beijing’s current plans to address steel overcapacity, “Even if this cut was over three years it wouldn’t be enough, let alone five years.”²⁰⁹ To meet its goal of 80 percent steel capacity

²⁰³ China’s State Council, “Full Transcript of the State Council Policy Briefing on May 20,” May 20, 2016. http://english.gov.cn/news/policy_briefings/2016/05/20/content_281475353671742.htm.

²⁰⁴ Xinhua, “China to Cut Steel Capacity by 100–150 Mln Tonnes in 5 Years,” February 4, 2016. http://news.xinhuanet.com/english/2016-02/04/c_135075575.htm; Bloomberg News, “China Vows to Tackle Steel Overcapacity with 2020 Cut Targets,” February 4, 2016. <http://www.bloomberg.com/news/articles/2016-02-04/china-vows-to-tackle-steel-overcapacity-with-2020-cut-targets>.

²⁰⁵ State Council of the People’s Republic of China, “State Council Urges Fulfilling Overcapacity Cut Targets,” July 27, 2016. http://english.gov.cn/premier/news/2016/07/27/content_281475402934823.htm.

²⁰⁶ Renmin University of China National Academy of Development and Strategy, “Report on China’s Zombie Firms: Current Situation, Origin, and Solutions,” July 27, 2016. Staff translation. <http://nads.ruc.edu.cn/displaynews.php?id=3913>; Christian Shepherd and Tom Mitchell, “China’s Steel Sector Hit by Losses,” *Financial Times*, February 1, 2016. <http://www.ft.com/intl/cms/s/0/338b4394-c8aa-11e5-be0b-b7ece4e953a0.html#axzz3yvts657m>.

²⁰⁷ China’s Ministry of Industry and Information Technology, “Public Comment on ‘The Use of Law to Promote a Comprehensive Standards for Production Capacity Reductions in Accordance with Regulations,’” August 12, 2016. http://zmhd.miit.gov.cn:8080/opinion/noticedetail.do?method=notice_detail_show¬iceid=1548.

²⁰⁸ Gabriel Wildau, “China Industrial Profits Grow Fastest Since 2014,” *Financial Times*, March 27, 2016. https://www.ft.com/content/9ecf0030-f3d1-11e5-9afe-dd2472ea263d?fcamp=published_links%2Frss%2Fworld%2Ffeed%2F%2Fproduct.

²⁰⁹ Bloomberg News, “China Vows to Tackle Steel Overcapacity with 2020 Cut Targets,” February 4, 2016. <http://www.bloomberg.com/news/articles/2016-02-04/china-vows-to-tackle-steel-overcapacity-with-2020-cut-targets>.

utilization by 2017, China would need to reduce excess capacity by approximately 225 million metric tons, or 112.5 million metric tons per year, assuming production remains unchanged.²¹⁰

Thus far, Beijing has not met its own production cut targets for steel, aluminum, or coal. August 2016 data from the NDRC indicates that China reduced its steel production capacity by only 21 million metric tons, or 47 percent of its 2016 target, in the first seven months of the year.²¹¹ Other estimates show that China has actually increased its steel production in 2016 and will look to continue to increase production in 2017.²¹² Similarly, coal plants cut production capacity by 95 million metric tons, only 38 percent of the annual target, in the first seven months of 2016.²¹³ Because many provincial governments fear mass unemployment as a result of reduced industrial production, they have been slow to implement the central government's reduction requirements. Yunnan Province, for instance, had met less than 10 percent of its annual target for reducing coal capacity by July 2016.²¹⁴ Asia-based financial services firm Nomura estimates that while Chinese producers have closed nearly 3 million metric tons of annual aluminum-producing capacity since 2010, they had added another 17 million metric tons as of November 2015.²¹⁵ In 2016, many of China's aluminum smelters, which had cut output to stem losses from falling prices at the end of 2015, are planning to increase production by 1.4 million metric tons from 2015 levels, including producing around 800,000 additional metric tons in the first half of 2016.²¹⁶

In addition to saying it will cut domestic production, Beijing has pursued a host of recent policy directives geared toward boosting both internal and external demand to absorb excess industrial capacity. The "One Belt, One Road"²¹⁷ and "Megacities" initiatives, along with projects funded through the Asian Infrastructure Investment Bank (AIIB), will help buy up some excess capacity by increasing Chinese

²¹⁰ Steel Net, "Comments on China's Steel Industry Adjustment Policy (2015 Revision)," April 20, 2015, 4.

https://www.steel.org/~media/Files/AISI/Public%20Policy/Letters/Steel_Industry_Adjustment_Policy_Comments.pdf.

²¹¹ Zhao Chenxin, "National Development and Reform Commission August News Conference on the Macroeconomic Situation and Relevant Issues," *National Development and Reform Commission*, August 16, 2016. Staff translation. http://www.ndrc.gov.cn/xwzx/xwfb/201608/t20160816_814915.html.

²¹² Duke University Center on Globalization, Governance, and Competitiveness, "Overcapacity in Steel China's Role in a Global Problem," September 2016, 12. http://www.americanmanufacturing.org/page/-/uploads/resources/OvercapacityReport2016_R3.pdf.

²¹³ Zhao Chenxin, "National Development and Reform Commission August News Conference on the Macroeconomic Situation and Relevant Issues," *China's National Development and Reform Commission*, August 16, 2016. Staff translation. http://www.ndrc.gov.cn/xwzx/xwfb/201608/t20160816_814915.html.

²¹⁴ Zhao Chenxin, "National Development and Reform Commission August News Conference on the Macroeconomic Situation and Relevant Issues," *China's National Development and Reform Commission*, August 16, 2016. Staff translation. http://www.ndrc.gov.cn/xwzx/xwfb/201608/t20160816_814915.html.

²¹⁵ Biman Mukherji, "Rising Chinese Production Keeps Lid on Aluminum Prices," *Wall Street Journal*, November 10, 2015. <http://www.wsj.com/articles/rising-chinese-production-keeps-lid-on-aluminum-prices-1447186082>.

²¹⁶ Bloomberg News, "China Ramps Up Aluminum Output as 20% Rally Allows Restarts," April 6, 2016. <http://www.bloomberg.com/news/articles/2016-04-06/china-ramps-up-aluminum-production-as-20-rally-allows-restarts>.

²¹⁷ **FOOTNOTE:** For more information on the "One Belt, One Road" initiative, see U.S.-China Economic and Security Review Commission, Chapter 3, Section 1, "China and Central Asia," in *2015 Annual Report to Congress*, November 2015, 391–418; and U.S.-China Economic and Security Review Commission, Chapter 3, Section 2, "China and Southeast Asia," in *2015 Annual Report to Congress*, November 2015, 448–449.

infrastructure projects both domestically and abroad. Meanwhile, “Made in China 2025” serves to repurpose and modernize China’s industrial sectors (for more on these initiatives, see Chapter 1, Section 3, “13th Five-Year Plan”).²¹⁸

Evaluation of China’s Nonmarket Economy Status

In its 2001 WTO accession agreement, China agreed to provisions allowing its trade partners to automatically treat China as a nonmarket economy (NME) for the purposes of AD enforcement for 15 years (for the full text of the relevant provision in China’s WTO accession agreement, see Addendum I, “Section 15 of China’s WTO Accession Agreement”). In other words, countries could use values from a third country in a similarly situated economic position—not Chinese prices or costs—for AD calculations, unless China could demonstrate market economy conditions prevailed in the relevant industry.²¹⁹ When Section 15(a)(ii) of its accession protocol expires on December 11, 2016, China argues it is entitled to automatic conferral of market economy status (MES).²²⁰ Some U.S. lawyers, particularly those who typically represent respondents in AD cases, argue the provision’s expiration eliminates authorities’ ability to use NME methodology against China, while others contend the WTO Anti-Dumping Agreement leaves open other possibilities to avoid using Chinese prices or costs in AD investigations.²²¹ On the other hand, some lawyers who typically represent U.S. manufacturers argue the provision’s expiration allows government authorities to use NME methodology, provided the petitioner can show market conditions do not prevail in a given Chinese industry.²²²

Granting China MES would reduce the margins of U.S. dumping duties imposed on Chinese exports.²²³ In situations involving imports from an NME, the WTO allows for the “normal value”—or the appropriate price in the market of the exporting country—of the products to be determined using data from a surrogate country. Since Chinese domestic prices and costs are often artificially suppressed by government subsidies, trading partners use surrogate country data to demonstrate that China is engaged in dumping.²²⁴ The amount

²¹⁸ Janet Hao and Andrew Polk, “Appraising Industrial Overcapacity—the Achilles Heel of Chinese Growth?” *Conference Board China Center for Economics & Business*, September 2015, 2.

²¹⁹ Alan Price, Timothy Brightbill, and Scott Nance, “The Treatment of China as a Non-Market Economy Country after 2016,” *Wiley Rein LLP*, September 15, 2015, 2.

²²⁰ China Trade Extra, “USCBC Urges Granting China MES This Year to Bolster Bilateral Relations,” January 21, 2016.

²²¹ China Trade Extra, “USCBC Urges Granting China MES This Year to Bolster Bilateral Relations,” January 21, 2016.

²²² China Trade Extra, “Xi Touches on Brewing Legal Fight over China’s Status in Dumping Cases,” October 14, 2015.

²²³ **FOOTNOTE:** Dumping is the act of introducing a product into another country’s market at less than its “normal value.”

“Normal value” is “the comparable price, in the ordinary course of trade, for the like product when destined for consumption in the exporting country.” Christian Tietje and Karsten Nowrot, *Myth or Reality? China’s Market Economy Status under WTO Anti-Dumping Law after 2016*, Policy Papers on Transnational Economic Law No. 34 (Transnational Economic Law Research Center, December 2011). <http://tietje.jura.uni-halle.de/sites/default/files/telc/PolicyPaper34.pdf>.

²²⁴ Christian Tietje and Karsten Nowrot, *Myth or Reality? China’s Market Economy Status under WTO Anti-Dumping Law after 2016*, Policy Papers on Transnational Economic Law No. 34 (Transnational Economic Law Research Center, December 2011).

by which the normal value of a product exceeds the Chinese price is used to calculate the AD duties applied to Chinese exporters.²²⁵ If China is designated as a market economy, its trading partners will not be able to use surrogate data to determine the normal value of Chinese goods. Under this scenario, dumping margins would likely be lowered significantly, further injuring U.S. companies harmed by China's anticompetitive activities.²²⁶

According to a November 2015 report commissioned by a group of U.S., Canadian, and Mexican steel industry associations, granting China MES would significantly limit countries' ability to offset China's anticompetitive activities and negatively impact the U.S. economy.²²⁷ The report found that granting MES to China would bring dumping margins to zero or nearly zero, hindering the effectiveness of AD laws and significantly harming steel industries of North American Free Trade Agreement (NAFTA) members. As a result, U.S. steel output, one of many U.S. industries damaged by Chinese overcapacity, would decline even further—by approximately \$21.2 billion—and U.S. economic welfare²²⁸ would decline by \$40.2 billion to \$46.5 billion.²²⁹ In addition, U.S. labor demand would shrink by \$29.6 billion (the equivalent of 400,000 to 600,000 workers).²³⁰

U.S. Criteria for NME Status

Under the U.S. AD law in the Tariff Act of 1930 [19 U.S. Code § 1677(18)], the Department of Commerce is responsible for determining whether a country is a market economy for the purposes of AD investigations, and whether MES will apply to the whole country or on a sector-by-sector basis. According to the U.S. AD statute, a "nonmarket economy country" is any foreign country that does not operate on market principles of cost or pricing structures, leading to sales that do not reflect a product's fair value.²³¹ There are six factors to be considered in the U.S. determination of MES:

1. The extent to which the currency of the foreign country is convertible into the currency of other countries;

<http://tietje.jura.uni-halle.de/sites/default/files/telc/PolicyPaper34.pdf>; U.S. International Trade Commission, "The Year in Trade 2014," July 2015, 61.

²²⁵ U.S. International Trade Commission, "The Year in Trade 2014," July 2015, 61.

²²⁶ U.S.-China Economic and Security Review Commission, *Hearing on China's Shifting Economic Realities and Implications for the United States*, oral testimony of Gary Hufbauer, February 24, 2016.

²²⁷ Manuel Molano Ruiz et al., "Assessment of the Probable Economic Effects on NAFTA of Granting Market Economy Status to China," *American Iron and Steel Institute*, November 10, 2015, iii.

²²⁸ **FOOTNOTE:** Economic welfare is defined as a measure of total national economic output, including consumption and investment items that contribute directly to economic wellbeing. UN Statistics Division, "Measure of Economic Welfare (MEW)," <http://unstats.un.org/unsd/environmentgl/gesform.asp?getitem=745>.

²²⁹ Manuel Molano Ruiz et al., "Assessment of the Probable Economic Effects on NAFTA of Granting Market Economy Status to China," *American Iron and Steel Institute*, November 10, 2015, iii.

²³⁰ Manuel Molano Ruiz et al., "Assessment of the Probable Economic Effects on NAFTA of Granting Market Economy Status to China," *American Iron and Steel Institute*, November 10, 2015, iii.

²³¹ Tariff Act of 1930, Pub. L. No. 103-465, 1930, codified at 19 U.S.C. § 1677(18).

2. The extent to which wage rates in the foreign country are determined by free bargaining between labor and management;
3. The extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country;
4. The extent of government ownership or control of the means of production;
5. The extent of government control over the allocation of resources and over the price and output decisions of enterprises; and
6. Such other factors the administering authority considers appropriate.^{232 233}

During the Commission's February 2016 hearing, three out of four witnesses argued China does not meet the qualifications for MES.²³⁴ In his testimony before the Commission, Alan Price, a partner at the U.S. law firm Wiley Rein, stated that joint ventures remain highly restricted in China's strategic sectors; the government maintains—and is even strengthening—its control of the means of production through central and provincial SOEs, and the state exerts extensive control over resource allocation.²³⁵ Furthermore, a review of China's economic policy reveals that its currency is not fully convertible, with the 13th FYP outlining goals to increase the RMB's convertibility by 2020.²³⁶ In addition, the AFL-CIO states that there is currently no system for collective bargaining between employers and employees in China.²³⁷

Countries rely on AD and CVD cases against China to protect themselves from the influx of government-subsidized goods imported below market value. Globally, between 1995 and 2014, 1,052 AD cases were initiated against China—759 of which resulted in the imposition of AD duties—the most of any country and over 700 cases more than were initiated against South Korea, the second-highest AD recipient (see Figure 7). During the same period, 90 CVD cases were initiated against China, also the most of any country.²³⁸ AD and CVD cases against China are becoming increasingly frequent, with the United States launching a total of 48 AD and CVD investigations in the first nine months of 2016, 28 of which involved Chinese goods (for a complete list of U.S. AD and CVD cases filed against China in 2016, see Addendum

²³² **FOOTNOTE:** Other factors could include effective enforcement of intellectual property rights, compliance with WTO subsidy obligations contained in China's protocol of accession, and discrimination against foreign goods and services. Terrence Stewart et al., "Any Change to China's Non-Market Economy Status Must Be Based on the Criteria Specified under U.S. Antidumping Law," *U.S.-China Economic and Security Review Commission*, August 18, 2005, 2.

²³³ Tariff Act of 1930, Pub. L. No. 103-465, 1930, codified at 19 U.S.C. § 1677(18).

²³⁴ U.S.-China Economic and Security Review Commission, *Hearing on China's Shifting Economic Realities and Implications for the United States*, oral testimony of Alan Price, Adam Hersh, and Bernard O'Connor, February 24, 2016.

²³⁵ U.S.-China Economic and Security Review Commission, *Hearing on China's Shifting Economic Realities and Implications for the United States*, oral testimony of Alan Price, February 24, 2016.

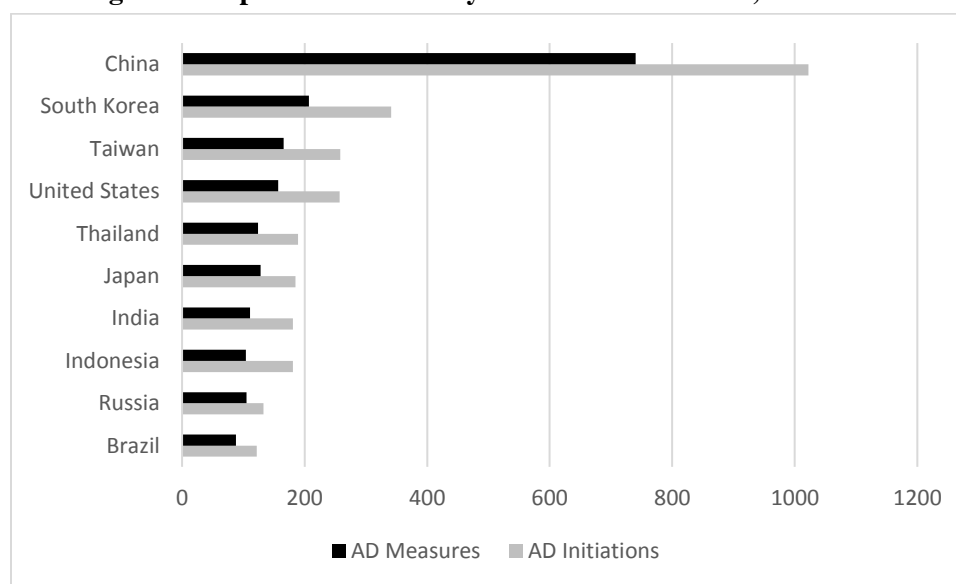
²³⁶ People's Republic of China, *13th Five-Year Plan on National Economic and Social Development*, March 17, 2016. Staff translation. http://www.gov.cn/xinwen/2016-03/17/content_5054992.htm.

²³⁷ American Federation of Labor and Congress of Industrial Organizations, "Labor Rights in China." <http://www.aflcio.org/Issues/Trade/China/Labor-Rights-in-China>.

²³⁸ Rui Fan, "China's Excess Capacity: Drivers and Implications," *Stewart and Stewart*, June 2015, 12.

II, “AD and CVD Investigations Initiated by the United States Against China, 2016”).²³⁹ Unsurprisingly, Chinese industries with excess capacity are the most common targets of trade remedy investigations, with 80 percent of the world’s AD and CVD cases against China concentrated in base metals, chemicals, machinery and equipment, textiles, rubber, plastics, stone, cement, and glass.²⁴⁰ Although the Department of Commerce has the authority to self-initiate AD and CVD cases, it has done so only once since 1991.²⁴¹

Figure 7: Top Ten Countries by AD Actions Received, 1995–2014



Source: Rui Fan, “China’s Excess Capacity: Drivers and Implications,” *Stewart and Stewart*, June 2015, 12.

Status of Deliberations

At a panel on China’s MES during the Commission’s February hearing on “China’s Economic Realities and Implications for the United States,” the majority of expert witnesses testified that granting China MES would limit countries’ ability to restore fair pricing in the market.²⁴² The debate over China’s MES revolves around two questions: whether China is entitled to automatic conferral of MES and, if not, whether it is a market economy and should be granted MES. The U.S. government has clarified its view on the first question, telling Chinese officials during a WTO meeting in July 2016 that the expiration of the accession protocol provision does not require member states to automatically grant China MES.²⁴³ In testimony before

²³⁹ U.S. International Trade Commission, “Antidumping and Countervailing Duty Investigations,” https://www.usitc.gov/trade_remedy/731_ad_701_cvd/investigations.htm.

²⁴⁰ U.S.-China Economic and Security Review Commission, *Hearing on China’s Shifting Economic Realities and Implications for the United States*, oral testimony of Alan Price, February 24, 2016.

²⁴¹ Antidumping and Countervailing Duties, codified at 19 C.F.R. § 351.225(b) (2015); U.S. Government Accountability Office, “Key Challenges to Small and Medium-Sized Enterprises’ Pursuit of the Imposition of Trade Remedies,” June 2013, 2. <http://www.gao.gov/assets/660/655493.pdf>.

²⁴² U.S.-China Economic and Security Review Commission, *Hearing on China’s Shifting Economic Realities and Implications for the United States*, oral testimonies of Alan Price, Adam Hersh, and Bernard O’Connor, February 24, 2016.

²⁴³ China Trade Extra, “U.S. to China: Non-Market Economy Status Doesn’t Automatically End in December,” July 14, 2016. <http://chinatradeextra.com/daily-news/us-china-non-market-economy-status-doesnt-automatically-end-december>.

the Commission, a panel of expert witnesses agreed that the United States and EU are not required to automatically grant MES to China in December 2016 when the relevant accession protocol provision expires; however, the panel was divided on whether China is currently a market economy or even on the path to become one in the near future.²⁴⁴ Experts on both sides of the debate conceded China is likely to take action at the WTO to resolve this disagreement, which could take years given the critical importance of the case and the backlog of cases currently in the WTO dispute settlement system.²⁴⁵

The United States' Perspective

While the United States seems unlikely to grant China MES in December 2016, no official statement on the matter has been made by the Department of Commerce aside from disputing China's claim that it is automatically granted MES after December 2016.²⁴⁶ The United States appears to be coordinating on the China MES issue with EU officials, including a meeting between the USTR, the Department of Commerce, and European Commission officials in late January 2016, as well as conversations with Matthias Fekl, the French minister of state for foreign trade and other G7 members, in June 2016.²⁴⁷ However, U.S. Trade Representative Michael Froman maintains discussions are not used to advocate for the EU to take a particular stance on the issue.²⁴⁸

The Department of Commerce has not explicitly rejected or endorsed China's MES claims, but officials in other U.S. government agencies have repeatedly warned against removing China's NME status. In conversations with their EU counterparts in December 2015, for instance, unnamed U.S. officials from the USTR and the Department of Commerce warned that granting China MES would amount to "unilaterally disarming" Europe's trade defenses against China.²⁴⁹ Six months later, a bipartisan group of 18 U.S. senators sent a letter to EU Trade Commissioner Cecilia Malmström urging the EU to rule against granting China MES. The letter stated granting China MES would "thwart global efforts to secure China's compliance with its international trade obligations," and "could have a destabilizing impact in certain global sectors, including the steel industry."²⁵⁰

²⁴⁴ U.S.-China Economic and Security Review Commission, *Hearing on China's Shifting Economic Realities and Implications for the United States*, oral testimonies of Alan Price, Adam Hersh, Gary Hufbauer, and Bernard O'Connor, February 24, 2016.

²⁴⁵ China Trade Extra, "Xi Touches on Brewing Legal Fight over China's Status in Dumping Cases," October 14, 2015.

²⁴⁶ China Trade Extra, "U.S. to China: Non-Market Economy Status Doesn't Automatically End in December," July 14, 2016. <http://chinatradeextra.com/daily-news/us-china-non-market-economy-status-doesnt-automatically-end-december>.

²⁴⁷ China Trade Extra, "French Minister Says U.S., EU Are Cooperating On China NME Status, as Is G7," June 10, 2016.

<http://chinatradeextra.com/daily-news/french-minister-says-us-eu-are-cooperating-china-nme-status-g7>; China Trade Extra, "USTR, Commerce Officials Discuss China MES with European Commission," January 29, 2016.

²⁴⁸ China Trade Extra, "USTR, Commerce Officials Discuss China MES with European Commission," January 29, 2016.

²⁴⁹ Christian Oliver, Shawn Donnan, and Tom Mitchell, "US Warns Europe over Granting Market Economy Status to China," *Financial Times*, December 28, 2015. <http://www.ft.com/intl/cms/s/0/a7d12aea-a715-11e5-955c-1e1d6de94879.html#axzz4AT6qjPlv>.

²⁵⁰ China Trade Extra, "Senators Warn Malmstrom against Giving China Market Economy Status," June 3, 2016.

The U.S. business community remains divided over whether to grant China MES. The US-China Business Council (USCBC), for instance, argues the United States should grant China MES as a way of building “confidence in the bilateral relationship” and solidifying the foundation for “mutually beneficial commercial relations.”²⁵¹ USCBC President John Frisbie goes a step further, arguing the United States is obligated under WTO law to automatically grant MES to China.²⁵² However, Jim Baske, the CEO of the North American division of ArcelorMittal, the world’s largest steel producer, and Mr. Ferriola of Nucor have been vocal in their opposition to granting China MES, with Mr. Baske stating that China “fail[s] the [MES] test on all six criteria.”²⁵³

Among U.S. experts, there are also differing interpretations regarding the validity of China’s MES claims. In his testimony to the Commission, Mr. Price stated that although legal opinion may be divided, the Chinese economy cannot be considered a market economy because “the series of distortions are so great in China that the internal prices and the pricing mechanisms that exist essentially are not set by what we would call reasonable rules of the road.”²⁵⁴ Adam Hersh, a visiting fellow at Columbia University, agreed with Mr. Price, stating in his testimony that “China’s economy [falls] short of the market economy criteria ... with a substantial role for government control unparalleled in other WTO member countries.”²⁵⁵ However, Gary Hufbauer, senior fellow at the Peterson Institute for International Economics, disagreed, advocating for a “mix-and-match” approach whereby the Department of Commerce determine on a case-by-case basis whether Chinese prices or costs reflect market conditions.²⁵⁶ In Dr. Hufbauer’s view, while China still has work to do instilling market principles into its economy, it is “more open than almost any other emerging country and has more foreign direct investment by far than any other emerging country,” and thus is deserving of MES on a sector-by-sector basis.²⁵⁷

The EU’s Perspective

The EU’s ruling on China’s MES claims could have significant implications for the United States and global economic growth. A 2015 report by the Economic Policy Institute examined the risks associated with an EU decision to unilaterally grant MES to China. According to the report, granting MES to China would

²⁵¹ China Trade Extra, “USCBC Urges Granting China MES This Year to Bolster Bilateral Relations,” January 21, 2016.

²⁵² China Trade Extra, “USCBC Urges Granting China MES This Year to Bolster Bilateral Relations,” January 21, 2016.

²⁵³ Victoria Guida, “Pinpointing the Massive TTIP Leak,” *Politico*, May 3, 2016. <http://www.politico.com/tipsheets/morning-trade/2016/05/pinpointing-the-massive-ttip-leak-canadas-freeland-the-three-amigos-ride-again-obama-presses-case-for-tpp-214085>.

²⁵⁴ U.S.-China Economic and Security Review Commission, *Hearing on China’s Shifting Economic Realities and Implications for the United States*, oral testimony of Alan Price, February 24, 2016.

²⁵⁵ U.S.-China Economic and Security Review Commission, *Hearing on China’s Shifting Economic Realities and Implications for the United States*, oral testimony of Adam Hersh, February 24, 2016.

²⁵⁶ U.S.-China Economic and Security Review Commission, *Hearing on China’s Shifting Economic Realities and Implications for the United States*, oral testimony of Gary Hufbauer, February 24, 2016.

²⁵⁷ U.S.-China Economic and Security Review Commission, *Hearing on China’s Shifting Economic Realities and Implications for the United States*, oral testimony of Gary Hufbauer, February 24, 2016.

increase EU imports of manufactured commodities by between \$80 billion and \$160 billion or more, and eliminate 1.7 million to 3.5 million EU jobs, as well as additional jobs in both upstream and downstream supplier industries around the world. This import growth would also increase EU trade deficits and reduce EU GDP by 1 to 2 percent in the first three to five years after MES was granted.²⁵⁸ A unilateral decision by the EU to grant China MES could reduce U.S. exports to the EU amid an influx of Chinese trade into the EU.²⁵⁹ To date, no studies have examined the potential U.S. job losses or economic impact on the United States if the EU grants China MES.

After a debate on the issue of China's status in January 2016, the European Commission decided to delay the conclusion of its deliberations until the second half of this year, pending more consultations.²⁶⁰ In contrast with the United States, the EU's termination of NME methodology for China would require a change in trade remedy law, which would be difficult to complete before the December 11 deadline.²⁶¹

While the European Commission has not formally ruled on the issue, reports indicate it is broadly in favor of granting China the status, and in December 2015 the legal service of the European Commission—tasked with making the EU's determination of China's NME status—endorsed the interpretation that China automatically graduates to MES in December.²⁶² Possibly in an effort to blunt the potential detrimental economic impact of granting MES to China, the European Commission is also reportedly considering changes to its trade remedy law enforcement.²⁶³ These changes, which would treat China as a market economy only if Beijing met its goals for reducing steel overproduction, are said to include elimination of the EU's "lesser duty rule" (effectively removing a cap on AD duties), strengthening antisubsidy enforcement by devoting greater resources to investigating Chinese subsidy programs, and grandfathering in existing AD orders against Chinese imports.²⁶⁴ However, EU Trade Commissioner Malmström has indicated there is no link between the trade law reforms being considered and the debate over China's

²⁵⁸ Robert E. Scott and Xiao Jiang, "Unilateral Grant of Market Economy Status to China Would Put Millions of EU Jobs at Risk," *Economic Policy Institute*, September 18, 2015, 1–3.

²⁵⁹ U.S.-China Economic and Security Review Commission, *Hearing on China's Shifting Economic Realities and Implications for the United States*, written testimony of Bernard O'Connor, February 24, 2016.

²⁶⁰ Duncan Robinson, "Brussels Delays Deciding on Status of China as 'Market Economy,'" *Financial Times*, January 13, 2016. <http://www.ft.com/intl/cms/s/0/eed175f2-ba12-11e5-bf7e-8a339b6f2164.html#axzz40XjnaSBo>.

²⁶¹ China Trade Extra, "Xi Touches on Brewing Legal Fight over China's Status in Dumping Cases," October 14, 2015.

²⁶² China Trade Extra, "Xi Touches on Brewing Legal Fight over China's Status in Dumping Cases," October 14, 2015; Christian Oliver, "EU Legislators Push Back on China's Bid for Market Economy Status," *Financial Times*, May 12, 2016. <http://www.ft.com/intl/cms/s/0/b71097f6-1840-11e6-b197-a4af20d5575e.html#axzz48TZAsZeY>.

²⁶³ Arthur Beesley, "Brussels Prepares Market Economy Compromise for China," *Financial Times*, July 20, 2016. <https://next.ft.com/content/9412fe0a-4dca-11e6-8172-e39ecd3b86fc#ixzz4Ex0XUEjT>.

²⁶⁴ Arthur Beesley, "Brussels Prepares Market Economy Compromise for China," *Financial Times*, July 20, 2016. <https://next.ft.com/content/9412fe0a-4dca-11e6-8172-e39ecd3b86fc#ixzz4Ex0XUEjT>.

MES.²⁶⁵ EU leaders have also agreed to form a working group with China to address concerns about Beijing's steel overproduction.²⁶⁶

Although the European Commission continues to weigh the decision, EU legislators rejected China's market economy claims via a nonbinding resolution in May 2016. The resolution, which was supported by 546 lawmakers while only 28 voted against and 77 abstained, indicated the EU Parliament's overwhelming objection to China's MES claims and sent a strong signal to the European Commission.²⁶⁷ David Martin, an EU Parliament member who voted in favor, told reporters after the vote, "In the current circumstances, recognizing China as a market economy at the WTO would be to tighten the noose around the UK steel industry's neck.... We must act now or soon there won't be any EU industry left to defend."²⁶⁸ In his testimony to the Commission, Bernard O'Connor, a trade lawyer with NCTM in Brussels, also warned against removing China's NME status, stating that the EU's unilateral grant of MES to China would undermine the effectiveness of EU trade defense laws and allow massive dumping into the EU market.²⁶⁹ Mr. O'Connor advocated for the United States and EU to coordinate their approach to China's MES claims, arguing that "the United States and the EU must stand together so as to be able to stand up to the unfair trade practices which emanate automatically from a nonmarket economy."²⁷⁰

Implications for the United States

Under President Xi, the Chinese government has tightened its control over the economy, enhancing its influence over state-owned and private firms alike and abandoning market-oriented economic reforms. As a result, direct government ownership of a company is no longer an accurate measure of Beijing's economic influence. Instead, the government has cemented its role as an economic decision maker in both the private and public sectors, exerting control through an array of financial, political, and extralegal tools on behalf of Beijing's national security or political interests. Because China's proposed SOE reforms seek to reaffirm and even strengthen state control while making limited attempts to incorporate market drivers, it is likely the problems inherent in China's state-run economy will continue to worsen.

²⁶⁵ Inside U.S. Trade, "Malmstrom Says No Formal Link between China MES and Trade Remedy Reform," June 6, 2016, <http://insidetrade.com/daily-news/malmstrom-says-no-formal-link-between-china-mes-and-trade-remedy-reform>.

²⁶⁶ Associated Press, "China, EU Agree to Steel Working Group amid Dumping Concerns," July 13, 2016, <http://bigstory.ap.org/article/635c4f3c329543f4b9f05efd7fd6cf3b/china-eu-agree-steel-working-group-amid-dumping-concerns>.

²⁶⁷ Christian Oliver, "EU Legislators Push Back on China's Bid for Market Economy Status," *Financial Times*, May 12, 2016, <http://www.ft.com/intl/cms/s/0/b71097f6-1840-11e6-b197-a4af20d5575e.html#axzz48TZAsZeY>.

²⁶⁸ Christian Oliver, "EU Legislators Push Back on China's Bid for Market Economy Status," *Financial Times*, May 12, 2016, <http://www.ft.com/intl/cms/s/0/b71097f6-1840-11e6-b197-a4af20d5575e.html#axzz48TZAsZeY>.

²⁶⁹ U.S.-China Economic and Security Review Commission, *Hearing on China's Shifting Economic Realities and Implications for the United States*, oral testimony of Bernard O'Connor, February 24, 2016.

²⁷⁰ U.S.-China Economic and Security Review Commission, *Hearing on China's Shifting Economic Realities and Implications for the United States*, oral testimony of Bernard O'Connor, February 24, 2016.

Beijing primarily seeks to enhance its control in economically and politically strategic industries. 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. Beijing's clear interest in maintaining control of strategic sectors suggests Chinese companies in these sectors are subjected to particularly high levels of government influence.

The government's support for economically and politically strategic industries provides China with a competitive advantage in key sectors and undermines the competitiveness of U.S. businesses and other global firms operating in accordance with market forces. One of the most pressing problems created by Beijing's state-led economic model is the global commodity glut, with rampant overcapacity in steel, aluminum, and other industrial products artificially lowering global prices below production costs. As a result, U.S. industries are struggling to compete, and many of the largest producers have been forced to shed capacity, cut employment, and reduce capital expenditures. In response to China's unfair trade practices, new tariffs have been applied on Chinese steel, and the private sector is aggressively pursuing trade enforcement action against China through AD and CVD cases. However, Chinese officials' continued reluctance to commit to detailed production cuts at international and bilateral fora, such as the G20 Summit and the Organisation for Economic Co-operation and Development Summit, and bilateral dialogues like the S&ED have resulted in increased overcapacity and losses for many U.S. companies—including more than 13,500 jobs in the U.S. steel industry since January 2015 alone. The influx of unfairly priced steel and aluminum imports from China also poses a national security threat to the United States, hollowing out industries that are essential for maintaining the critically important defense industrial base.

Trade remedies provide important relief to companies injured by China's anticompetitive activities, but their utility will be diminished if China is granted MES. If China is deemed a market economy by the Department of Commerce, dumping margins for AD cases against China will be significantly reduced, removing U.S. businesses' best recourse for limiting price distortions from China. A U.S. Government Accountability Office study found China already accounts for 95 percent (or \$2.2 billion) of unpaid AD duties and CVDs imposed on U.S. goods imports in 2015.²⁷¹ To maintain a free and fair global competitive landscape, the United States has reportedly been coordinating with European Commission officials to ensure the EU does not grant unilateral MES to China, although U.S. government officials maintain that discussions are not used to advocate for a particular stance on the issue.

²⁷¹ U.S. Government Accountability Office, "CBP Action Needed to Reduce Duty Processing Errors and Mitigate Nonpayment Risk," July 2016, 17. <http://www.gao.gov/assets/680/678419.pdf>.

Conclusions

- Despite repeated pledges to let the market play a “decisive role” in resource allocation, Beijing continues to use state-owned enterprises (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. While proposed SOE reforms have made little progress incorporating market drivers into SOE activities or addressing the country’s growing credit crisis, they have taken steps to strengthen state control—particularly in sectors involving the government’s political or economic interests.
- For the foreseeable future, it is highly unlikely that the CCP will subject SOEs to free market reforms. Such reform would diminish the CCP’s control in strategic sectors, through which it directs the economy. In addition, real structural reforms would substantially increase unemployment in the short term and undermine entrenched interests within the CCP leadership.
- In China’s state capitalist system, government ownership is not the sole measure of Beijing’s economic influence. Beijing has fostered a unique ecosystem whereby the government is at the center of the economy, with state control extended through an array of measures, including financial support, political connections, and extralegal control to SOEs and private enterprises alike. As such, all Chinese companies’ economic activity—not just the activity of state-owned firms—is conducted in support of the state’s goals and policies. This is particularly true for Chinese firms operating in strategic sectors.
- The CCP continues to use SOEs as the primary economic tool for advancing and achieving its national security objectives. There is therefore an inherently high risk that whenever an SOE acquires or gains effective control of a U.S. company, it will use the technology, intelligence, and market power it gains in the service of the Chinese state, to the detriment of U.S. national security.
- China’s economic policies have fueled a commodity boom, which, coupled with the recent economic slowdown, has created a vast oversupply of industrial goods like steel, aluminum, and coal. Beijing has repeatedly stated its commitment to eliminating excess capacity, yet progress has been extremely slow—and in some cases nonexistent.
- Rather than closing industrial production facilities and laying off workers, Beijing is exporting its surplus production to the detriment of U.S. and other foreign competitors. As a result, U.S. industries are struggling, with steel and aluminum producers shedding capacity, cutting employment, and reducing capital expenditures.
- Amid an influx of unfairly priced steel imports from China, American steel manufacturing jobs are being eliminated, dramatically reducing the United States’ critically important defense industrial

base. If the U.S. steel industry is hollowed out, U.S. manufacturers of military equipment and machinery will be forced to import components from China and elsewhere, raising the possibility that products of subpar or compromised quality could endanger U.S. military personnel and limit the country's ability to respond to a military threat.

- China argues it should be automatically granted market economy status (MES) after a provision in its World Trade Organization (WTO) accession protocol expires on December 11, 2016. A review of the U.S. statutory test for determining whether an economy can be classified as a market economy—including the extent to which the currency is convertible; the extent to which wage rates are determined by free bargaining between labor and management; the extent to which joint ventures or other investments by foreign firms are permitted; the extent of government ownership or control of the means of production; and the extent of government control over the allocation of resources—reveals that China is not currently a market economy and is not on the path to become one in the near future.
- To address global economic imbalances created by China's state-led economic model, the United States has relied on trade remedies consistent with its WTO obligations. However, if China is granted MES in December 2016, dumping margins for antidumping cases will be significantly reduced, removing an important tool U.S. businesses rely on to limit losses taken from price distortions in China's economy.

Recommendations

The Commission recommends:

1. Congress amend the statute authorizing the Committee on Foreign Investment in the United States (CFIUS) to bar Chinese state-owned enterprises from acquiring or otherwise gaining effective control of U.S. companies.
2. Congress direct GAO to prepare a report examining the extent to which large-scale outsourcing of manufacturing activities to China is leading to the hollowing out of the U.S. defense industrial base. This report should also detail the national security implications of a diminished domestic industrial base (including assessing any impact on U.S. military readiness), compromised U.S. military supply chains, and reduced capability to manufacture state-of-the-art military systems and equipment.
3. Congress require that under antidumping and countervailing duty laws, Chinese state-owned and state-controlled enterprises are presumed to be operating on behalf of the state and, as a result, do not have standing under U.S. laws against unfair trade to block a case from proceeding.
4. Congress create an office within the International Trade Administration whose sole purpose is to identify and initiate antidumping and countervailing duty cases to ensure a more effective and timely response to China's unfair trade practices.
5. Congress enact legislation requiring its approval before China—either the country as a whole or for individual sectors or entities—is granted status as a market economy by the United States.

Addendum I: Section 15 of China's WTO Accession Agreement

The MES debate is centered on paragraph 15(a)(ii) of Section 15—a vaguely worded provision of China's WTO Accession Protocol set to expire in December 2016—that allows an importing WTO member to use surrogate AD calculation methodologies against unfairly priced Chinese imports. The relevant subparagraphs of Section 15 are as follows:

15. Price Comparability in Determining Subsidies and Dumping

Article VI of the General Agreement on Tariffs and Trade (GATT) 1994, the Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 ("Anti-Dumping Agreement"), and the Subsidies and Countervailing Measures Agreement shall apply in proceedings involving imports of Chinese origin into a WTO Member consistent with the following:

(a) In determining price comparability under Article VI of the GATT 1994 and the Anti-Dumping Agreement, the importing WTO Member shall use either Chinese prices or costs for the industry under investigation or a methodology that is not based on a strict comparison with domestic prices or costs in China based on the following rules:

(a)(i) If the producers under investigation can clearly show that market economy conditions prevail in the industry producing the like product with regard to the manufacture, production, and sale of that product, the importing WTO Member shall use Chinese prices or costs for the industry under investigation in determining price comparability;

(a)(ii) The importing WTO Member may use a methodology that is not based on a strict comparison with domestic prices or costs in China if the producers under investigation cannot clearly show that market economy conditions prevail in the industry producing the like product with regard to manufacture, production, and sale of that product.

.....

(d) Once China has established, under the national law of the importing WTO Member, that it is a market economy, the provisions of subparagraph (a) shall be terminated provided that the importing Member's national law contains market economy criteria as of the date of accession. In any event, the provisions of subparagraph (a)(ii) shall expire 15 years after the date of accession. In addition, should China establish, pursuant to the national law of the importing WTO Member, that market economy conditions prevail in a particular industry or sector, the NME provisions of subparagraph (a) shall no longer apply to that industry or sector.²⁷²

²⁷² World Trade Organization, "Accession of the People's Republic of China," November 23, 2001.

931 **Addendum II: AD and CVD Investigations Initiated by the United States against China, 2016**

Investigation Title	Start Date	Phase
Corrosion-Resistant Steel Products from China, India, Italy, Korea, and Taiwan	1/4/2016	Final
Certain New Pneumatic Off-the-Road-Tires from China, India, and Sri Lanka	1/8/2016	Preliminary
Certain Biaxial Integral Geogrid Products from China	1/13/2016	Preliminary
Certain Amorphous Silica Fabric from China	1/20/2016	Preliminary
Truck and Bus Tires from China	1/29/2016	Preliminary
Porcelain-on-Steel Cooking Ware from China	2/1/2016	Fourth Review (Expedited)
Hydrofluorocarbon Blends and Components from China	2/1/2016	Final
Magnesium from China	2/1/2016	Second Review (Expedited)
Stainless Steel Sheet and Strip from China	2/12/2016	Preliminary
Carbon Steel Butt-Weld Pipe Fittings from Brazil, China, Japan, Taiwan, and Thailand	3/1/2016	Fourth Review (Expedited)
Frozen Warmwater Shrimp from Brazil, China, India, Thailand, and Vietnam	3/1/2016	Second Review (Full)
1,1,1,2 - Tetrafluoroethane from China	3/3/2016	Preliminary
Petroleum Wax Candles from China	3/7/2016	Fourth Review (Expedited)

1-hydroxyethylidene-1, 1-diphosphonic acid from China	3/31/2016	Preliminary
Aluminum Extrusions from China	4/1/2016	Adequacy
Carbon and Alloy Steel Cut-to-Length Plate from Austria, Belgium, Brazil, China, France, Germany, Italy, Japan, Korea, South Africa, Taiwan, and Turkey	4/8/2016	Preliminary
Ammonium Sulfate from China	5/25/2016	Preliminary
Paper Clips from China	6/1/2016	Fourth Review (Full)
Cased Pencils from China	6/1/2016	Fourth Review (Full)
Iron Mechanical Transfer Drive Components from Canada and China	6/8/2016	Final
Heavy Forged Hand Tools from China	7/1/2016	Adequacy
Large Residential Washers from China	7/26/2016	Final
Glycine from China	8/1/2016	Adequacy
Certain Biaxial Integral Geogrid Products from China	8/22/2016	Final
Amorphous Silica Fabric from China	9/1/2016	Final
Sulfanilic Acid from China and India	9/1/2016	Adequacy
Truck and Bus Tires from China	9/6/2016	Final

Carbon and Alloy Steel Cut-to-Length Plate from
Austria, Belgium, Brazil, China, France, Germany,
Italy, Japan, Korea, South Africa, Taiwan, and
Turkey

9/16/2016

Final

932 Source: U.S. International Trade Commission, "Antidumping and Countervailing Duty Investigations."
933 https://www.usitc.gov/trade_remedy/731_ad_701_cvd/investigations.htm.