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BY

THE PEOPLE'S REPUBLIC OF CHINA

TOWARDS GRADUATION TO MARKET ECONOMY

STATUS

IN TRADE DEFENCE INVESTIGATIONS

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EXECUTIVE SUMMARY

China's current economic structure is an increasingly modern and market-based system. Important and very substantial reform efforts have been undertaken, or are under way. The assessment of Market Economy Status (MES) is not a judgement of the general functioning of the Chinese economy or a political judgement on whether a market economy *per se* exists in China. It focuses on a number of specific technical areas related to the influence of state intervention on prices and costs in China. These influences, where they exist, are obviously relevant to trade defence investigations, because they determine the extent to which the costs of exports from China reflect the unfair influence of state intervention.

The conclusion of this report is that China now has in place almost all the legislation which is necessary for granting of Market Economy Status. That is a considerable achievement. The focus has now switched to the effective implementation of these laws which are crucial for the functioning of any market economy. Market Economy status is assessed on the basis of five criteria. In the judgement of the European Commission, China has clearly fulfilled one of these criteria, Criterion 2 which relates to the absence of state intervention in enterprises linked to privatisation and the absence of non-market forms of exchange or compensation such as barter trade. China has made considerable progress on the remaining four.

Remarkable progress has been achieved for Criterion 3, concerning the use of appropriate modern accounting standards. Here, the introduction of new accounting standards in China should be considered a major development and evidence of effective implementation now becomes the outstanding issue. The agreement of China to set up an independent study to gauge progress on implementation of these standards is a useful step forward.

Substantial progress has also been made by China on Criterion 4, concerning bankruptcy, intellectual property and property laws. A new Bankruptcy Law and the new Property Law both entered into force in 2007. A new Anti-Monopoly Law was also adopted in 2007 and will enter into force in August 2008. In the same way as for accounting standards the key question remains one of effective implementation. China needs to demonstrate that these laws are being universally and consistently implemented and enforced. On the issue of bankruptcy it would be necessary for China to introduce its announced implementation guidelines and then provide evidence of a successful transition phase which is currently ongoing. With regards to property rights the key is whether China can show that new law has in practice substantially increased private property rights. More effective implementation of legislation concerning IPR also needs to be demonstrated as the degree of IPR violations remains high.

While positive developments, such as the introduction of the new Enterprise Income Tax Law have been registered, progress on Criterion 1, concerning government intervention in the allocation of resources or business decisions in the economy, is less evident. Almost all analysts concur that the Chinese state is still playing an important role in price setting in significant sectors of the economy, e.g. the energy sector. This has a widespread effect on the costs of production of many goods. Progress on this criterion obviously requires evidence that this type of state intervention has ceased.

Progress has also been slow for Criterion 5, concerning the existence of a financial system independent from the state. While improvement is evident, for example in the area of corporate governance at commercial banks, problems are still widespread, notably the state

controls on interest rates which have a direct impact on all economic operators. This and problem of access to credit for private operators (normally SMEs), will need to be addressed and are key elements for fulfilment of this criterion.

In summary, this report acknowledges the considerable progress that has been made in China over the last year towards the technical status of MES for trade defence investigations. It aims to be as clear as possible about the action which remains to be taken, in the estimation of the European Commission, for that status to be awarded. The Commission remains strongly committed to working with China to achieve that. As well as working closely with China in existing dialogues, the European Commission commits to undertaking a similar stock-take to the current report before summer 2009.

1. INTRODUCTION

1.1. Background

In 2003 China requested that the European Union grant it market economy status (MES) for the purpose of the trade defence investigations. This is a technical status that reflects the general absence of state interventions in costs and prices in an economy – an important factor in any trade defence investigation. At that time China and a number of other countries were considered by the EU as economies in transition. This means that under the relevant provisions of the EU's anti-dumping laws (Council Regulation 384/96) prices and costs in China cannot normally be used in trade defence investigations, because they are routinely distorted or rendered unreliable by state intervention and are not a credible measure of the true costs of production. In their place, and in accordance with WTO rules, trade defence investigations use analogue data from other economies that have been accorded MES.

An MES Working Group was established in 2004 to facilitate the exchange of information between the Chinese authorities and the services of the Commission. These exchanges form the basis for the current report. It was agreed in 2007 that a detailed assessment would be carried out in 2008 of the status of China's request for MES. To this end, contacts between the two sides have been intensive and the Chinese authorities have responded to a large number of questions posed by the services of the Commission. The MES Working Group last met in Beijing and Shanghai in April 2008. The work of the Group included substantive discussions with counterparts from competent ministries of the Chinese Government as well as field visits to meet representatives of the financial sector and individual Chinese manufacturers. These provided a crucial insight into recent developments in the Chinese economy.

It is important to recall that this assessment is a technical exercise for the sole purpose of trade defence investigations. In this context, the conclusions should not be viewed as a judgement of the general functioning of the Chinese economy or a political judgement on whether a market economy *per se* exists in China.

1.2. Criteria

MES requests are evaluated on the basis of five criteria which aim to establish whether the economic conditions in the country concerned have evolved to the extent that prices and costs can reliably be used for the purpose of trade defence investigations. The five criteria stipulate that in the country concerned there must be:

1. a low degree of government influence over the allocation of resources and decisions of enterprises, whether directly or indirectly (e.g. public bodies), for example through the use of state-fixed prices, or discrimination in the tax, trade or currency regimes.
2. an absence of state-induced distortions in the operation of enterprises linked to privatisation and the use of non-market trading or compensation system
3. the existence and implementation of a transparent and non-discriminatory company law which ensures adequate corporate governance (application of international accounting standards, protection of shareholders, public availability of accurate company information).
4. the existence and implementation of a coherent, effective and transparent set of laws which ensure the respect of property rights and the operation of a functioning bankruptcy regime.
5. the existence of a genuine financial sector which operates independently from the state and which in law and practice is subject to sufficient guarantee provisions and adequate supervision.

To obtain technical Market Economy Status for trade defence investigations all five criteria must be met. Since China's request in 2003 to be granted MES a first preliminary assessment of the application was made in June 2004 which concluded that China had met criterion 2, as state-induced distortions in the area of privatisation had been removed, as had the practice of barter trade. This report updates that assessment and focuses on the remaining four criteria.

2. ASSESSMENT

2.1. **Criterion 1:** *Degree of Government influence over the allocation of resources and decisions of enterprises, whether directly or indirectly (e.g. public bodies), for example through the use of state-fixed prices or discrimination in the tax, trade or currency regime.*

To meet this criterion, a state must demonstrate that it does not exercise an undue influence over the allocation of economic resources in the economy or decisions of companies. This could take the form of price fixing, obligations to produce for export, restrictions imposed on exports of raw materials or subsidies for industrial inputs. These things are all relevant to trade defence investigations because they directly impact on the costs of producing goods in that economy, often unfairly for competitors.

2.1.1. **Restrictions on export and imports**

In their replies of November 2007, the Chinese authorities acknowledged that export obligations had been adopted by the Chinese government to promote exports and earn foreign exchange during the first stage of China's opening of the economy to the world at the end of the 1980's and early 1990's. However, with the advances made by the Chinese economy since then, the policy of export obligations has been withdrawn and the obligations themselves have been abolished. In accordance with its WTO commitments, in 2000 and 2001 the Chinese Government revised the relevant laws to abolish local content requirements, restrictions on foreign exchange holdings, and other legal requirements inconsistent with WTO rules. These revisions have enabled foreign enterprises in China to enjoy full autonomy in deciding the level and ratio of products devoted to the domestic and international markets. However these areas need to be further scrutinized to ensure that commitments and obligations are implemented, including concerning technology transfer.

The replies of the Chinese authorities also acknowledge that some enterprises may still have not revised their Articles of Association to reflect all the revised laws, but insist that this has no legal or practical meaning given the general removal by law of all export obligations. With fairly large foreign reserves, China has no need to maintain the concept of export obligations.

As the last WTO Secretariat Trade Policy Review emphasized, in the last two years China has continued gradually to liberalize its trade and trade-related policies. In particular, it has eliminated tariff-rate quotas on some items and reduced the number of lines subject to automatic import licensing requirements¹.

However, in a number of cases export restrictions, including licensing and quotas are applied to limit the export of certain products notably raw materials. The application of such restrictions on exports tends to increase the domestic supply of the product concerned and as a consequence their prices may be lower than would otherwise be the case. This can provide Chinese firms with an advantage over international competitors as such a policy may disturb the equilibrium of demand and supply in influencing prices on international markets.

¹ WTO – Trade Policy Review – China (WT/TPR/S/199)

2.1.2. Price fixing and utility rate setting

Some evaluations of this question emphasize that many emerging economies intervene in price setting for some products to a certain degree. They also note, however, that the Chinese Government still plays an important role in price setting in areas such as energy². For example, in 2005, it introduced a coal-electricity price adjustment mechanism, under which the prices of coal power generation and electricity from coal-fired power plants are allowed to fluctuate in response to the changing market prices for coal³. This allows operators to benefit from distorted energy costs. The Chinese government recently announced a moratorium on power coal price increases until the end of 2008.

Evaluations also underline that the NDRC (National Development and Reform Commission) still monitors the overall price levels, as well as the prices of major goods and services and that it conducts inspections of prices of products and services such as electricity, grain, fertilizers, drugs and refined oil. While the NDRC is responsible for setting the prices of these goods at national level, most adjustments to prices are made at the provincial level by the local pricing bureaus. In making these adjustments, the provinces can take into account factors affecting supply and demand, such as production costs, government policies, prices of related products and consumer purchasing power. The same applies for industrial inputs, such as water, gas and electricity. The Government also appears to use utility rates to change the competitive position of certain sectors and thereby promote or discourage their expansion⁴.

For oil a system of wholesale guidance prices is used. This is based on the weighted monthly average of spot prices in international markets with final retail oil prices being allowed to vary by up to 8% from that price. However, guidance prices are not changed frequently in a way that reflects changes in international prices and this means oil prices are substantially lower in China than international market prices. China subsidizes the two major state-owned refiners, but not the distributors. This policy leads to market disruptions as shown by the fact that in 2007, the NDRC directed the top two oil refiners to increase supply in certain provinces that had experienced shortages of oil products. The same applies to coal prices, where coal-fuelled power plants are reported to face shortages over peak periods⁵.

2.1.3. Taxation

In their replies of November 2007 the Chinese authorities explained that in the past, China applied policies that exempted certain exported products from taxes or had lower tax rates applied. For example, any enterprise with foreign investments would enjoy enterprise income tax exemption or reduction when the annual value of its export products accounted for 70% of the total value of its production. The position is now different with the introduction of the new *Enterprise Income Tax Law* which entered into force 1 January 2008 and abolished all tax reductions and tax exemptions for exported products.

The recent tax reforms (effective as of January 2008) aim to create a uniform and standard tax system for domestic and foreign-invested enterprises (FIEs), to simplify the tax regime, to broaden the tax base and to lower income tax rates. Under the new law, FIEs and domestic

² UBS Investment Research, 10 January 2008

³ WTO – Trade Policy Review – China (WT/TPR/S/199)

⁴ Electric Power Law (1996), Water Law (2002), Differential Power Price for Energy Intensive Industries (2004)

⁵ China Power: Clear Regulation Questionable Execution – Morgan Stanley 25 July 2008

firms have a standard rate of 25% and both are eligible for the same tax incentives. A number of tax preferences for FIEs are scheduled to be eliminated.

As the latest Trade Policy Review by the WTO notes, the prevalence of export taxes tends to distort domestic prices in China and this may be relevant for TDI investigations. As for export restrictions these export taxes tend to increase the domestic supply of products concerned. As a consequence their domestic prices tend to be lower than international prices. Thus export taxes may indirectly assist domestic downstream processing of the products concerned⁶.

The fact that VAT and excise tax may be rebated on exports of certain products is also problematic⁷. VAT rebate rates on exports are often substantially lower than the VAT rates actually paid. The difference between the two rates constitutes a levy on exports, which may, in turn, constitute assistance to downstream processing of the products affected. For example, in 2005 China removed an 8% VAT rebate for exports of primary aluminium and, in addition, imposed a 5% interim export tax. Removal of the VAT rebate (as with the imposition of export taxes) tends to reduce exports of primary aluminium and thus increase its domestic supply. As a result the domestic price of primary aluminium is kept artificially lower than would otherwise be the case. Primary aluminium is a major input into aluminium foil which upon exportation qualifies for a VAT rebate of 13% rather than the full rebate of 17%⁸.

2.1.4. Measures to promote industrial policy goals

China's current industrial development policy objectives include the continuation of privatization (corporatization) and the rationalization or even closure of state-owned enterprises (SOEs)⁹.

Some observers stress that although China still adopts five-year plans, these are no longer detailed line-by-line plans but rather set broad development objectives¹⁰. Others however argue that direct intervention in the economy remains a tool of industrial policy. It appears that various centrally-determined "catalogues" identifying sector-specific industrial development policies (e.g. for steel, automobiles, cements),¹¹ are used to channel resources into certain activities that the government believes are important for China's continued growth and development. This may be a legitimate approach by the Chinese authorities to attain its overall policy objectives. The only question for the current assessment is whether such policies distort domestic competitive conditions in favour of domestic operators and thereby make domestic prices and costs unreliable.

The government (State Council) classifies industries into several categories such as "encouraged", "restricted" or "prohibited". Projects that do not fall into these three groups are "permitted"¹². The current objectives are reflected in the most recent "Catalogues" issued by

⁶ WTO – Trade Policy Review – China (WT/TPR/S/199)

⁷ "Measures on Administration of Tax Rebate (Exemption) for exports" issued by the State Administration of Taxation

⁸ WTO – Trade Policy Review – China (WT/TPR/S/199)

⁹ NDRC, "Report on the Implementation of the 2006 Plan"

¹⁰ UBS Investment Research, 10 January 2008

¹¹ WTO – Trade Policy Review – China (WT/TPR/S/199)

¹² WTO – Trade Policy Review – China (WT/TPR/S/199) and "China: Description of Selected Government Practices and Policies affecting Decision-making in the Economy" USITC Publication 3978, December 2007

the NDRC¹³. It is stipulated that financial institutions should grant loans to support investment projects in the “encouraged” category and to refuse any new investment projects in the “restricted” category. Specific credit “guidance” is provided to commercial banks to implement industrial policy objectives. Investment projects in the “*encouraged*” category are also supported by preferential tax policies. Existing investment projects in the “restricted” category are allowed to continue, but industries are given a fixed time period in which to upgrade their production processes and/or products.¹⁴ This type of preferential treatment provided to certain sectors or operators may artificially reduce the actual cost of production for the operators concerned.

A specific example of a targeted subsidization program is described in a recent survey. This is the so-called “Going Out” programme, which was designed to create a significant number of “national champions” (the target date is 2010) to support the global expansion of Chinese companies. The main activities which receive different forms of state support (mainly soft loans) are the extraction of natural resources (such as oil, gas and metal), textiles, automotive, maritime transport, ICT, energy and construction. In 2007, the total credit provided to activities under the program was USD 21.8 billion, a 35% increase over 2006. In the coming years the “Going Out” program will be the largest source of subsidies to business focused on export and overseas investment activity. This funding is only available to Chinese companies selected by the Government¹⁵.

The central government's policy of supporting the development of brand names is a further concern in this area and is closely related to the “Going Out” program. In this context the authorities set the objective that over 40% of export enterprises should own their independent brand. The ultimate aim is that the export of branded goods should exceed 20% of the total exports of China. These “brand name” export enterprises are also given priority for loans, R&D funds, as well as preferential loans and other support policies for manufacturing, processing or assembly of goods in foreign countries. Export credit insurance companies are also encouraged to list name brand export enterprises as “priority support clients”¹⁶.

2.1.5. Input subsidization

A recent USITC report suggests that for certain basic raw materials direct price subsidization is used in China. For example, crude and processed oil continue to be considered as key reserve materials and are subject to price controls. Although the price of crude oil is formally pegged to international market rates, in periods where prices are rising, the difference between domestic and international prices appears to widen. Prices of processed oil products are still managed by the NDRC and are only indirectly pegged to crude oil. Processed oil products are priced based on the average price of international crude, plus “adequate” profit for refineries

¹³ Catalogue of Guidance Regarding Industrial Structural Adjustment issued by NDRC, December 2005 which applies equally to domestic enterprises and FIEs, the latter being also subject to Catalogue for Foreign Investment Industries, last revised in November 2007

¹⁴ Catalogue of Guidance Regarding Industrial Structural Adjustment issued by NDRC, December 2005 together with “Major Measures to Promote the Adjustment of Industrial Structure”

¹⁵ China Government Subsidies Survey” by Anne Stevenson-Yang, Twin Poplars LL, EU-China Trade Project, 2007

¹⁶ Directive on Supporting the Development of Name Brands for export by Ministry of Commerce, 5 June 2005

as determined by the NDRC, import tariffs and cost of transportation. Oil companies can change the final retail price by up to 8%¹⁷.

Some analysts stress that for most of the past few years the Government has not been subsidizing oil prices significantly except in 2005 and in recent months when crude prices have clearly risen well above domestic wholesale prices¹⁸. Government intervention has however increased recently, as demonstrated by the Government's announcement on 19 June 2008 to increase oil prices as of 20 June 2008. The move should bring some relief to domestic refineries which have previously been making losses and ensure a stable supply of oil in the market¹⁹.

Electricity trading in China remains low and mainly carried out under the direction of the government, which approves prices and amounts to be traded. Most of the trading continues to take place between generators and the provincial electricity companies which own most of the transmission and part of the distribution grids within the provinces. The provincial governments determine the monthly annual amounts that can be traded. Electricity prices, including rates at which power generating enterprises sell to the network/grid and the transmission and distribution tariffs and end-user tariffs are still controlled by the Chinese government. Transmission and distribution tariffs are fixed by the NDRC, taking into account factors such as reasonable determination of returns and fair burden sharing²⁰. In 2005 the NDRC issued a notice and several regulations to reform the electricity tariffs but this reform is still in progress²¹.

Some recent studies also indicate that certain industries in China have access to low energy prices and it appears that the steel industry has benefited disproportionately from energy subsidies because of its high consumption of coal²² which coupled with other direct and indirect government benefits to the sector can make the domestic prices/costs of production unreliable.

Recent TDI investigations in China have indicated certain competition distortions, notably in the steel sector. Some recent TDI investigations have indicated that the input costs in China tend to be distorted, mostly due to upstream state subsidies²³. The findings of other cases also demonstrate regular state influence with regard to the costs of production inputs in China. For example investigations revealed very low electricity prices, which in some cases were below the costs of production.²⁴

2.1.6. Conclusion

Overall the Chinese state is moving away from interference in the functioning of the economy. A number of recent measures appear to underpin this trend. However, discretionary setting of prices and the fixing of utility rates continues to be practiced and this can affect the

¹⁷ "China: Description of Selected Government Practices and Policies affecting Decision-making in the Economy" USITC Publication 3978, December 2007

¹⁸ UBS Investment Research – China Focus: "How long can energy subsidies last?" (April 2008)

¹⁹ Ibid

²⁰ WTO – Trade Policy Review – China (WT/TPR/S/199)

²¹ NDRC online information at: <http://txt.newhua.com/txt/10945.htm>

²² Harvard Business Review June 2008 by Usha C. V. Haley and George T. Haley

²³ L302

²⁴ L296, L109, L296, L234, L100

costs of production for domestic operators in China. The recent tax reform is a positive development in creating a level playing field for all operators in China. However, more time is needed to see the impact of that reform in practice. The continued application of certain direct or indirect restrictions on exports and imports and the subsidisation of inputs have implications on domestic input prices which are relevant for TDI purposes. In a wider sense, coordinated financial programs to promote the implementation of the government's industrial policy objectives also appear to influence competitive conditions.

For these reasons it is not possible to conclude at this time that this criterion has been fulfilled. In order to met this criterion it would be necessary for the Chinese authorities to demonstrate that the forms of intervention outlined above had been discontinued.

2.2. Criterion 2: *Absence of state-induced distortions in the operation of enterprises linked to privatisation (i.e. “carry over” from the old system). Absence of use of non-market trading or compensation system (e.g. barter trade)*

This criterion is considered as fulfilled by the earlier assessment. No external information suggests changing the 2004 assessment on this point.

2.3. Criterion 3: *Existence and implementation of a transparent and non-discriminatory company law which ensures adequate corporate governance, the application of international accounting standards, protection of shareholders` rights and public availability of accurate company information*

In order to meet this criterion it is necessary for a state to demonstrate that within its economy companies are subject to a transparent and rigorous system of company law. This includes being subject to international accounting standards and international standards for shareholder protection and transparency. Transparent and reliable company records are absolutely central to trade defence investigations, as they are the chief means of determining a company's costs.

2.3.1. Management of state assets, corporate governance

As explained by the Chinese authorities in their replies to Commission questions, the relevant Regulations²⁵ provide that enterprises that manage state-owned assets enjoy total operational autonomy. In this context, Chinese authorities also explained that the state-owned assets supervision and administration authority must support the independent operation of enterprises in accordance with the law and cannot interfere in their production and operational activities apart from performing the responsibilities of an investor. This goal of operational autonomy is supported by shareholding reform in state-owned enterprises and the corporate governance reform of wholly state-owned enterprises.

In 2003, China decided to focus its reform of state-owned enterprises on adopting a shareholding system. In the past few years, SASAC and the relevant local authorities have promoted such reform to an extent that some enterprises have even obtained overseas public listing. By the end of 2006, the number of publicly listed (non-financial) state shareholding companies had risen to 808 in China. This included 201 shareholding companies with central enterprises as controlling shareholders publicly listed on domestic stock-exchanges. These

²⁵ The Interim Regulations on Supervision and Management of state-owned Assets of Enterprises of PRC

efforts have not only attracted the attention of investors, but it has also enhanced the healthy and market-oriented operation of enterprises.

The Chinese authorities also noted that China has also reformed and improved the corporate governance of wholly state-owned enterprises. In June 2004, SASAC issued the *Notice on Pilot Program of the Establishment and Improvement of the Board of Directors of Wholly State Enterprises*, under which a board of directors was created for some wholly state-owned enterprises. It is planned to have such boards established for all wholly state-owned companies before 2010. SASAC's role of acting on behalf of state investors of any wholly state-owned companies will be performed mainly through these boards of directors. These boards will have the authority to select and employ management.

Some analysts²⁶ acknowledge that for listed companies (joint-stock limited companies that issues "listed" shares and are traded on stock exchanges) the highest authority now rests with shareholders and the board of directors is the decision-making body. The corporate governance of listed companies is regulated not only by the Company Law but also the Securities Law²⁷ and a series of rules including the Code of Corporate Governance for Listed Companies²⁸ and the Guidelines for Internal Control System of Listed Companies²⁹. These are mandatory rules which define the basic principles for corporate governance, protection of investor interests, the competences of directors, supervisors, managers and other senior management in listed companies. These legislative developments are positive in terms of enhancing the introduction of modern corporate governance into Chinese enterprises.

However, others analysts consider that corporate governance reforms have focussed on amending structures while leaving the same decision-makers in place. SASAC appears to be active in preparing strategic decisions and exercises the rights of monitoring, appointment and dismissal of managers of the operating entities. The latter, granted autonomy in daily activities, also have seats as executive members on the board of directors³⁰.

Thus the reform of China's SOEs remains a major challenge. Nevertheless it can be seen that the process of reorganisation, "corporatization" and partial privatisation of SOEs driven by SASAC has improved the performance of these enterprises. This includes their standards of corporate governance (e.g. setting management targets and introduction of auditing of commercial performance). It should be also underlined that as a key component of the rationalisation process SASAC not only encourages solvent SOEs to list on domestic (or foreign) stock exchanges but allows enterprises with more debts than assets to close³¹. Further restructuring of SOE's is being undertaken in accordance with the *Opinion on Guidelines for Promoting the Restructuring of state-owned Assets and SOEs*³². These are major positive achievements.

²⁶ UBS Investment Research, 10 January 2008 and WTO – Trade Policy Review – China (WT/TPR/S/199)

²⁷ The Securities Law was most recently amended in October 2005 and entered into force on 1 January 2006

²⁸ Issued by the China Securities Regulation Commission and the State Economic and Trade Commission in January 2002

²⁹ Issued by the Shanghai Stock Exchange on 5 June 2006

³⁰ "From Party/State Regulation to 'Network Executives': the crisis of exclusive corporate governance reform in China" by Chan Yang and Richard Sanders, *Journal of Contemporary China* (53), November 2007

³¹ WTO – Trade Policy Review – China (WT/TPR/S/199)

³² Issued by the State Council in December 2006

However, it should be noted that the outcome of recent TDI investigations confirms a degree of influence of the state in the corporate decision-making process. The reasons for not granting Market Economy Treatment to some companies concerned include the prevalence of state influence in the decision-making process, including in the form of restrictions on the granting of business licenses and the over-representation of state shareholders on company boards.³³

2.3.2. Accounting Standards

The Chinese authorities have noted that implementation of the new law on "Accounting Standards for Business Enterprises" (introduced on 1 January 2007) began last year for listed companies and will extend to other categories of operation over time. The Chinese authorities are investing substantially in promoting swift implementation, training a large number of accountants and disseminating information to companies to help the application of these accounting standards. This is expected to produce convincing results. The Ministry of Finance and the China Securities Regulatory Commission are responsible for supervising the implementation of accounting standards by listed companies and the operation of accounting firms and asset appraisal firms engaged in the securities business.

Analysts confirm that the new accounting law consisting of a new Basic Standard and 38 Specific Standards are in line with international norms and, cover nearly all of the necessary topics as set out in current International Financial Reporting Standards (IFRS)³⁴.

However, at present, given the lack of trained accountants and efficient enforcement mechanisms at central and local levels, most of the enterprises in China, including banks, do not adhere fully to IFRS. Nevertheless the Chinese government appears to be making serious efforts to change this.

The outcome of recent TDI investigations in China continues to demonstrate some weaknesses in the implementation of IFRS by Chinese operators³⁵. In the context of TDI investigations one of the most important source of information are reliable accounting records. Therefore it is essential that effective implementation of these internationally recognised accounting principles should be convincingly demonstrated.

This issue was discussed with the competent Chinese authorities at the last MES Working Group meeting held in Beijing on 9-10 April 2008. In view of the importance of this area in the MES process, it is very a positive development that it was agreed that an independent expert study would be jointly prepared to evaluate the effective implementation of international accounting standards in China. This expert study is expected to be completed in the first half of 2009.

2.3.3. Conclusions

While the European Commission acknowledges the significant reform in China in the area of company standards and transparency, it does not conclude that the terms of MES Criterion 3 have yet been met.

³³ L296, L109, L55, L94, C265, L75, L100

³⁴ "China's New Accounting Standards" by Deloitte

³⁵ L109, C265, L317, L100, L94, L205, L55, L296

The introduction of a new Company Law in China is clearly a positive development. Also the adoption, amendment and refinement of a number of relevant laws and rules, including the Securities Law and Code of Corporate Governance for Listed Companies, should provide a suitable legal framework for improving business practices including corporate governance in Listed Companies. The adoption of a shareholding system is also an important step, but its final impact on corporate governance remains to be seen. SASAC's operations in terms of helping SOEs to streamline are positive, but some continued interference with managerial decisions has also been reported. The inclusion of foreign partners could do much to further improve corporate governance in Chinese enterprises, in particular if they were allowed to have influence on both board composition and policies. These are the developments that the European Commission will track closely in assessing future progress on this criterion.

The entry into effect of the new Accounting Standards for Business Enterprises is a major step forward and now the focus shifts to the effective implementation of those standards throughout the Chinese economy. The preparation of an independent study to evaluate implementation, which is expected to be completed in the first half of 2009, will provide important insight into this work.

2.4. Criterion 4: *Existence and implementation of a coherent, effective and transparent set of laws which ensure the respect of property rights including intellectual property rights and the operation of a functioning bankruptcy regime*

To meet this criterion a state must demonstrate that within its economy an effective legal regime operates with respect to property rights, bankruptcy, and the protection of intellectual property. Ambiguities over private ownership are important in trade defence investigations, because they can effect access to credit by private companies, and non-payment of royalties for the use of intellectual property can obviously constitute an unfair cost distortion.

2.4.1. Property rights

In 2004 the Chinese Constitution was amended to explicitly recognize private property. Article 11 states: "Individual, private and non-public economies that exist within the limits prescribed by law are major components of the socialist market economy. The state protects the lawful rights and interests of individual and private economies and guides, supervises and administers individual and private economies". The private ownership rights of domestic firms were given further support through the passage of the Property Law (effective as of October 2007) in which, for the first time, it was indicated that the Government "recognized and protects the legal position and development rights of all market participants equally". Analysts acknowledge the recent advances made by China in securing the right of private ownership under Chinese law are very positive.

It should however be underlined that verifying land ownership rights can be difficult in China, as the country still lacks a fully operational land-registration system and access to land-transaction records is not always easy to obtain. These ambiguities over private ownership rights should be clarified to increase the ability of private firms to have access to credit from

main Chinese banks who reportedly favour SOEs partly because of their clear ownership structure³⁶.

2.4.2. Intellectual property rights

Most analysts observe that China has established a detailed legal framework on IPR which deserves recognition. Efforts to align their IPR laws with international standards and to enforce IPR through administrative actions and judicial measures have been made. However a lack of effective and appropriate enforcement mechanisms has hindered progress. It should be added that burdensome requirements, low penalties and weak legal enforcement of IPR do not make deterrence effective enough³⁷.

If IPR rights are not always respected and royalties are not paid, then costs and prices of products, including input products, do not reflect their real economic value and can act as a significant cost distortion for certain products. This remains a concern in the context of TDI investigations.

2.4.3. Bankruptcy procedures

In the replies provided by the Chinese authorities on 6 May 2008 a detailed explanation was given on the state of play concerning implementation of bankruptcy procedures in China. China's new Bankruptcy Law was adopted on 27 August 2006 during the 23rd session of the Standing Committee of the 10th session of the People's Congress and is implemented from 1st June 2007. It takes into account advanced foreign bankruptcy legal arrangements and China's judicial practice, as well as China's specific socialist market economy system.

The new law contains standard international practice but also some China-specific provisions relating to the protection of workers of the bankrupt company, the bankruptcy of state owned enterprises, of commercial banks, of securities companies, insurance companies and other financial institutions. Regulations have also been published to guide the implementation of the new bankruptcy law.

The administrator system foreseen in the bankruptcy procedure is a legal arrangement that is inspired by developed countries' bankruptcy laws and practices and takes into account the needs of China's judicial practice. The creation of an administrator's system will prove very useful so as to ensure the timely, efficient and fair handling of bankruptcy cases.

The new law provides for a transition period for the introduction of the new bankruptcy system. During a relatively long period after the entry into force of the Bankruptcy Law, Courts of different levels will be confronted with transition problems as both old and new systems will operate in tandem. The authorities are still in the process of drawing up detailed guidance on the implementation of the new laws.

It is clear that the training of specialists in bankruptcy matters is important for effective implementation. In this regard, the training of judges and administrators is crucial. For the

³⁶ "Firms Ownership and Investment Efficiency in China" – IMF Working Paper (WP/07/9) - 2007

³⁷ Study on the future opportunities and Challenges of EU-China Trade and Investment Relations, No. 12 of 2007, Exploring China's IP Environment – Emerging Market Group – by Paul Ranjard and Benoit Misonne

training of judges, China has introduced a standard and internationally recognised training system.

Most independent analysts agree that the introduction of China's new Bankruptcy Law (June 2007) is a positive development. It sets out three procedures for insolvent enterprises: reorganization, reconciliation and liquidation³⁸. The adoption of supportive measures³⁹ to facilitate implementation of the Law is also a positive step.

But despite these advances, the 2007 Bankruptcy Law does not apply to the 2000 worst-performing SOEs. Large commercial banks are not at all subject to “exit” pressure should they become untenable. Smaller local or rural banks have been closed or consolidated but larger banks have not been affected, although most large institutions have been formally insolvent for most of the past decade⁴⁰. Efficient enforcement of the Law is impeded also by a lack of trained judges and other bankruptcy experts despite government efforts to rectify this. Consequently the number of bankruptcy proceedings is very low compared to the size of the Chinese economy, suggesting that the law is inadequately applied. The fact that creditor banks often only recover 3-10% of their claims, that restructuring alternatives to liquidation remain limited and that secondary markets for assets are still underdeveloped⁴¹ all suggest overall the Chinese bankruptcy system is still in the early phases of implementation.

However it should be added, that through “policy-led” bankruptcies which began in 1994, the government encouraged SOEs with “long-term losses” to effectively declare bankruptcy which helped streamline the structure of the Chinese economy. These closures of uneconomic enterprises, through government-encouraged bankruptcy filings proved to be an efficient means of rationalisation. The downside is that, in contrast to standard practice, under “policy-led” bankruptcies the remaining assets of these firms are used to assist the reallocation of employees instead of paying-off debts. This has a direct impact on the accumulation of NPLs by banks and casts doubts on the commercial nature of lending by these banks.⁴² It appears that so-called “policy-led” bankruptcies are to be completed by the end of 2008 and thereafter all SOE bankruptcy cases are to be conducted in accordance with the new Law on Bankruptcy.

As the implementation of this law is still in progress a full assessment cannot be made at this time, but indications by the Chinese authorities lead to the conclusion that the transition period would be completed early next year. On that basis a complete analysis of the implementation can be carried out in 2009.

2.4.4. Competition policy

China has adopted an Anti-Monopoly Law (in force from 30 August 2007 and effective as of 1 August 2008) so as to promote and ensure that all companies can develop and compete on a level playing field. The law aims at preventing restrictive agreements and the abuse of dominant position and at fostering the most efficient companies and eliminating the weakest ones. It includes also provisions on merger control. What is important and positive is that the

³⁸ WTO – Trade Policy Review – China (WT/TPR/S/199)

³⁹ Employment Contract Law (2007), Employment Promotion Law (2007)

⁴⁰ UBS Investment Research, 10 January 2008

⁴¹ World Bank, “Bankruptcy of State Enterprises in China”

⁴² UBS Investment Research, 10 January 2008

Anti-Monopoly Law applies in a uniform and equal way to all monopolistic behaviour of all Chinese or foreign companies, including SOEs.

While protecting IPR, the law also seeks to prevent and control abusive IPR exclusions and behaviours so as to ensure competition and preserve the interests of consumers. Another positive element is that China's Anti-Monopoly Law is inspired by the EU experience in the field of antitrust legislation.

China's Anti-Monopoly Law stipulates that the State Council will set up an Anti-Monopoly Commission that will be in charge of organising, coordinating and guiding the implementation of the new law. It will: 1. explore and develop the competition policy; 2. organise studies and assess the overall competition situation on the market, publish the relevant assessment reports; 3. develop and publish Antitrust Guidelines; 4. coordinate administrative works on Anti-trust implementation; and 5. fulfil any other mandate given by the State Council.

Pursuant to Article 31 of the Antitrust Law, mergers and acquisitions of domestic companies by foreign investors may be subject to competition investigations should they affect national security. This is a common practice internationally and cannot serve to block all mergers and acquisitions by foreign investors on national security grounds. However, this can also be a source of problems since the content of these "national security reviews" are not defined in the Law.

Most analysts contend that the lack of a comprehensive competition law has left China vulnerable to anti-competitive conduct by private firms and SOEs. The adoption of an Anti-Monopoly Law is a therefore a major step to address this situation.

The Law specifies that its principal purpose is to "prohibit monopolistic conduct" and to "ensure the healthy development of a socialist market economy". It allows exemptions to the prohibition on restrictive agreements. These exemptions apply if it can be demonstrated that an agreement is aimed at improving technology and R&D, ensuring legitimate interests in foreign trade, upgrading product quality, reducing cost and unifying specifications and standards of a product, enhancing competition capacity of SMEs and realizing social and public interests such as saving energy and protecting the environment⁴³.

2.4.5. Conclusions

While the European Commission acknowledges the considerable progress made with respect to protecting private and intellectual property in China, it does not conclude that the terms of Criterion 4 have yet been met.

The further recognition of the role of the private sector and the protection of its rights under new Chinese legislation is a positive step. However, some ambiguity remains as to the legal status of private assets and that may have detrimental effect on private companies, including on access to credit. This distorts the provision of credit in the Chinese economy in favour of state-owned companies. Progress can be acknowledged in the area of establishing detailed legislation for IPR protection, but further steps are needed to address the remaining problems of effective enforcement. Both of these issues may have an impact on the costs of credit and production in China and are therefore relevant for TDI investigations.

⁴³ WTO – Trade Policy Review – China (WT/TPR/S/199)

The adoption of the new Bankruptcy Law is also a major development in allowing market forces to work more freely in the Chinese economy. Currently the implementation of the Law is ongoing and efforts are being employed to overcome the difficulties of transition from the old standards to the new. Lack of qualified experts is also an issue.

The adoption of the Anti-Monopoly Law is another major positive development in establishing the legislative framework of a functioning market economy but the implementation of this new law is yet to come and therefore its real impact on ensuring competitive business environment in China remains to be demonstrated.

2.5. Criterion 5: *Existence of a genuine financial sector which operates independently from the state and which in law and practice is subject to sufficient guarantee provisions and adequate supervision*

To meet this criterion a state must demonstrate that its financial sector operates free from state control and is governed by commercial standards in terms of the cost of credit. These things are central to trade defence investigations, because access to credit at special rates constitutes an obvious and unfair competitive distortion in favour of a company.

2.5.1. Access to credit by private sector (SMEs)

In their replies the Chinese authorities argued that neither the Government nor the banks discriminate against any enterprises with regard to loans, whether they are state-owned, joint-stock or private enterprises. The determining factor in issuing loans to private enterprises is their debt-servicing ability not their ownership. The Government has adopted a policy of encouraging and supporting private enterprises rather than setting obstacles for them in obtaining loans. Private enterprises that have good credit record and strong debt servicing ability should have no difficulty in getting loans.

It was argued by the Chinese authorities that perhaps the real reason why SMEs may have difficulty in getting loans is that, for the time being, most SMEs have only a limited credit record and are thus high-risk borrowers. In addition, they do not have adequate assets as guarantees for the banks and their financial capabilities are limited. A further problem for Chinese SMEs is that intangible assets are not taken into consideration as guarantee by the banks. It is reasonable that banks are very prudent in issuing loans to some SMEs in an effort to ensure the quality and security of their loans. The Chinese government has attached great importance to solving the problems faced by SMEs in getting loans and has taken various measures in this regard. The PBOC and other related departments under the State Council jointly promulgated over 20 policies or regulations such as the *Notice on Further Improving the Financial Services to Small and Medium Enterprises*, for the financing of SMEs.

While the situation is evolving, it should still be noted that private firms find it more difficult than SOEs to obtain financing from local banks in China⁴⁴. The Chinese financial system continues to be dominated by state-owned banks and traditionally favours SOEs over private firms. 70% of loans made by state-owned commercial banks are directed to SOEs; although according to most estimates their share in GDP is below 30%. However, financing channels for private firms - typically SMEs - do appear to have improved. For example an SME Board was established in the Shenzhen Stock Exchange to facilitate access to credit and the China

⁴⁴ "Firms Ownership and Investment Efficiency in China" – IMF Working Paper (WP/07/9) – 2007

Banking Regulatory Commission (CBTC) also announced measures to improve the situation⁴⁵. Nevertheless financial constraints continue to impair their development⁴⁶.

In particular when financial discipline is weak and there is excess demand for credit, banks naturally ration funds to those with the most reliable track record which means that the private sector does not have anything close to equal access to the banking system⁴⁷. The lack of national credit ratings system and the absence of credit history with major banks represent a problem for private firms because SOEs are perceived to be lower-risk, are larger and are of course backed by the Government⁴⁸.

Exchange of credit (cross) guarantees by companies to ensure access to loans appears to be frequent practice among Chinese operators as demonstrated by some recent TDI investigations.

2.5.2. Interest rates

According to the Chinese authorities, in view of the continued increase of net savings, China's interest rates have shown a general downward trend since 1996. From 2005, net savings have generally increased substantially. China argues that, to some degree, this is because of the trade surplus, which directly triggers excessive fund liquidity which may lead to lower interest rates. This would show that China's interest rate movement is basically in line with its macro economic background performance instead of being kept at a low level by the Government to support exports. However Commission experts note that although Chinese real GDP growth is slightly slowing, from 11.9% in 2007 to around 10% in 2008 (forecast), actual growth continues to exceed estimated potential growth.

The Chinese authorities indicated that benchmark interest rates is determined by the PBC and is subject to periodic adjustment. When adjusting the interest rate levels, the PBC follows the monetary policy objectives as set out in the "Law of the People's Bank of China" and takes into account the overall situation with regard to trends in domestic prices, investments, consumers' considerations as well as in the balance of international payments etc. Banks are free to decide rates charged taking account of customer's risk rating, including external rating, financial index, industrial landscape and business competition. For certain customers, the interest rate may be lowered but by no more than 10% from benchmark rate. For customers with a less favourable risk rating, the interest rate may float upwards and the margin will be decided by the banks. In fact, based on the benchmark rate the credit interest rate is decided by the market. Following interest rate reform, commercial banks have continued to upgrade their techniques for deciding interest rate and for improved internal management system.

In response to Commission questions, the Chinese authorities argued that at present the interest rates of recent commercial loans from Chinese commercial banks have all been decided in accordance with business principles. Since January 2004 the upper limit of interest rates at commercial banks and urban credit unions has increased from 1.3 times the

⁴⁵ "Country Report: China" by the Economist Intelligence Unit – June 2007

⁴⁶ WTO – Trade Policy Review – China (WT/TPR/S/199)

⁴⁷ Formal Finance and Trade Credit during China's Transition – World Bank Policy Research Working Paper No. 4204 – 2007

⁴⁸ "China: Description of Selected Government Practices and Policies affecting Decision-making in the Economy" USITC Publication 3978, December 2007

benchmark rate to 1.7 times, while that at rural credit unions has increased to two times the benchmark rate.

Unlike in most other banking systems, where banks compete for customers based on creditworthiness and interest rates, banks in China are not permitted to determine interest rates on these considerations⁴⁹. Interest rates in China are set by the PBC and state bank interest rates are essentially equal to prevailing PBC interest rates. Therefore it appears that normally less creditworthy SOEs do not pay higher interest rates than more creditworthy borrowers⁵⁰. This means that lending rates by banks do not properly reflect the true costs of borrowing and this issue needs to be carefully addressed. According to the Law on Commercial Banks (1995), interest rates are to be set by commercial banks “in line with the upper and lower limits for interest rates prescribed by the People's Bank of China”. Commercial banks may charge lending rates above benchmark (but not below) and offer deposit rates below (but not over) benchmark. The ceilings on the deposit rates are still fully binding.⁵¹

2.5.3. Banking reform, improving lending practice, respecting prudential standards

In response to Commission questions the Chinese authorities explained in their written replies that in terms of lending practice, China's banking system is changing positively with a) a significant improvement in credit to private enterprises (non-public-ownership enterprises), b), a gradual increase of loans to private enterprises by state-owned banks and c) the entire banking system becoming increasingly more diversified.

The Chinese authorities argue that commercial banks must now carry out business in accordance with the law free from any interference. The four major banks have transformed their internal mechanisms and have established corporate governance which has begun to play an important role. In order to ensure the implementation of prudential standards and healthy, comparatively risk-free operations by local banks, financial supervision has established a well-structured and clearly defined system for prudent regulation.

Chinese officials note that rules and measures have been reviewed and consolidated and other relevant regulations have been promulgated to promote the sound development of the banking industry. Other laws and regulations have stipulated the index scope of the capital adequacy ratio, deposit-credit and liquidity ratio and loan concentration. Supervision of banking institutions has also been strengthened to promote the prudent operation of banks.

In practice, led by PBC, China has made great headway in the building of a credit system. Currently the bank credit register system by the PBC covers over 90% of the credit information of enterprises and individuals and it is becoming an important reference standard for bank lending. It will lay a solid foundation for the market-based lending activities.

China will also further push forward the construction of a unified country-wide database of enterprises and individual credit information. The legal framework for the credit system will be built following the principles of central planning, nurturing the market, opening in an

⁴⁹ Formal Finance and Trade Credit during China's Transition – World Bank Policy Research Working Paper No. 4204 – 2007

⁵⁰ "China: Description of Selected Government Practices and Policies affecting Decision-making in the Economy" USITC Publication 3978, December 2007

⁵¹ UBS Investment Research, 10 January 2008

orderly manner and maintaining security. In addition, efforts will be made to promote the building of a credit industry standard and credit market and strengthen the public awareness campaign of credit and related financial knowledge with view to creating a good social credit environment.

In restructuring the Agricultural Bank, the Chinese government plays an important guiding role in developing the general principles and orientations of the whole reform. Today, the Agricultural Bank's external audit, asset evaluation, legally required investigations and other fundamental processes are still underway and are developing significantly. The design of the reform plan is also still in progress.

In the next phase, it will be necessary to draw the lessons of the experience gathered when reforming three other state owned commercial banks in order to support the work related to the handling of non-performing assets, recapitalisation by the state and financial restructuring, as well as the setting up of a shareholding company.

Most external analysts agree that banking reform in China has made significant progress towards the transformation of China's major banks into internationally competitive joint-stock commercial banks with an appropriate corporate structure, adequate capital, stringent controls, safe and sound business operations. The reforms of the major banks follow international best practices, but this process is not yet complete.

However, International standards are sometimes implemented selectively. Nevertheless, even the selective implementation of international standards represents an important improvement. Many technical improvements have been introduced, which makes the banking sector more transparent for national as well as international stakeholders. On the other hand, the lack of independence of supervisory bodies may undermine the credibility of reported information. This lack of independence is coupled with several technical departures from international practices, most importantly classification rules that favour lending to projects backed by the Government⁵².

Lending and deposit-taking have been partially deregulated since 2004 but some constraints remain. The Law on Commercial Banks (1995) requires commercial banks to take into consideration “the needs of the national economic and social development” and “follow the guidance of the industrial policies of the state”. Accordingly, the Central Bank and other administrative authorities encourage commercial banks to adapt their lending to specific borrowers in light of relevant government policies. Industry representatives in China reported that local banks are subject to indicative lending policies directed by the PBC regional offices. These guidelines, which vary by region, indicate which sectors and firms should receive priority attention for loans in accordance with government's industrial development policy. Foreign banks are not required to follow these guidelines⁵³.

Further problems in the banking sector based on reports from investors present in China include delays in obtaining licensing, restrictions on provision of services and lending restrictions compulsory reserve ratio and high capital requirements for branches.

⁵² "Banking Reform in China: Driven by International standards and Chinese specifics" by Zdenek Kudrna, October 2007

⁵³ Citigroup data on China's banking industry, August, 2007

2.5.4. Non-performing loans (NPLs) and credit risk assessment

Chinese authorities note that China has implemented a five-category classification system for bank loans according to their inherent risks under the *Guidelines on Loan Risk Classification*, in which NPLs cover three categories, namely sub-standard, doubtful and loss-making. In addition, the related data of publicly-listed banks is subject to examination by external auditors. By the end of March 2007 the NPL ratio of Chinese commercial banks was 6.63%. The decreasing NPL ratio of major Chinese banks is the result of both recapitalisation and credit risk management. Recapitalisation has enabled the banks to shake off the burden of previous huge NPLs caused by various complicating factors, while strengthened credit risk management has provided banks with a long-term mechanism of NPL control.

In recent years the five major banks in China have taken steps to study the best practices of the world's leading banks by tightening internal controls and speeding up risk management reforms. They have improved management within the banks and strengthened their capability to manage commercial credit. All in all, the five major banks have been working hard to establish a long-term mechanism for credit risk prevention and control, which has proved quite effective.

In 1999, China successively founded four asset management companies - China Huarong, China Great Wall, China Orient and China Cinda - essentially in charge of the management and disposal of non performing loans' assets bought from state-owned Banks. From 2004 until 2005, the Bank of China, the Chinese Construction Bank, Industrial and Commercial Bank of China (ICBC) went through a shareholding reform and got rid of bad loans by selling them through tenders to these four Asset Management Companies, which disposed of them and handled the loans' losses on the basis of the mandate given by the Ministry of Finances.

Non performing creditor's rights bought by the Asset Management Companies can be divided into three main categories. The first category concerns cases where the company has already declared bankruptcy when the creditor's rights were bought. The second category concerns cases where despite not having legally declared bankruptcy, the company is effectively bankrupt and has ceased trading. The third category relates to companies in difficulty in repaying their borrowings. Today there are no statistics regarding the number of debtors that have declared bankruptcy during the process carried out by Asset Management Companies.

Analysts observe that the “Big Four” commercial banks have always dominated China's banking sector and have been the primary source of financing for SOEs. Therefore they continue to be burdened with large NPLs. As a result of vast re-capitalization operations, asset quality has improved in recent years (albeit in a period of rapid loan growth) but continues to be a principal concern. At the end of the first quarter of 2007 the ratio of NPLs over total loans of major commercial banks reached an all-time low of 7.1% down from almost 25% in 2002. About 46% of the current stock of NPLs comes from the agricultural sector⁵⁴. However, these figures reflect only NPLs in the balance sheets of banks and do not contain the NPLs which have been transferred to the so called asset management companies (owned by the state). In addition, a large proportion of loans in bank's balance sheets are “special mention” loans. These loans are estimated to represent 7.8% of commercial bank loans and form a grey area between normal and non-performing loans. In case of less favourable economic

⁵⁴ CBRC (2007), Annual Report 2006, Appendix 8-8

conditions asset quality deterioration may become more apparent and undermine sustainability⁵⁵.

In general Chinese banks still need to develop a greater capacity to conduct effective credit-risk analysis on potential customers. China has not yet developed a fully operational clearinghouse of information on company or individual credit histories. One of the reasons China's banks tend to favour loans to SOEs is this difficulty of conducting an effective credit risk analysis on potential borrowers and SOEs are perceived to present lower-risk.

2.5.5. Role of policy banks

Policy banks, depending on their functions, provide loans to different borrowers. The China Development Bank (CDB) specializes in financing of infrastructure. The Agricultural Development Bank (ADBC) mainly provides funds to Government to purchase grain, cotton and edible oil. The Export-Import Bank of China (Chexim) provides credit to the buyer or seller in the export and import sector. With the deepening market-oriented reforms in China, policy banks now face significantly changed market conditions. Their mandate and operational conditions are such that many of their previous policy-related business have gradually turned into commercial businesses. For example the CDB has a very low NPL rate (under 2% since 2003) and it mainly finances its lending from domestic and foreign markets without guarantees provided by the Government.

The situation other two policy banks is quite different, as their operations are still commercially not competitive, particularly in the case of ADBC whose lending is for the purchase of basic agricultural products. China is pushing for more reform of policy banks. For the CDB the aim is for it to leave full autonomy in its operations so that it assumes responsibility for its own risks, profit and losses. An open and transparent market bidding system will also be adopted in the policy-related business of the ADBC and Chexim with more emphasis on market-oriented principles.

China's policy banks have the primary role of implementing the development objectives set by the Chinese government. This category of banks includes notably the China Export-Import Bank and the State Development Bank, which have a broad policy agenda covering, among other things, supporting major national infrastructure projects and "national champions". The NDRC is charged with the drafting of the national credit plan promulgated by the PBC to the banks at each levels of government. The credit plan sets a ceiling for the loans that may be granted to a given industry in each year. Once the overall level of loans is determined the central authorities assign percentages that may be lent to each level of governance.

The provincial, county and city level banks are all assigned a certain amount of credit that they can grant. Each level in the system is subject to certain conditions on the range of interest rates in can charge. Over the last couple of years, a policy of targeted financing of selected sectors and firms has been pursued. This is partially implemented in the framework of the so called "Going Out" program designed to create 30-50 state-run national champions by 2010 whose aim would be to expand abroad. In these efforts by the Government policy banks play

⁵⁵ WTO – Trade Policy Review – China (WT/TPR/S/199)

key role. According to "Going Out" guidelines interest rates on loans should be at least two percentage points lower than "commercial bank rates"⁵⁶.

2.5.6. Conclusions

The banking environment continues to improve in China. While acknowledging the progress that has been made in the area of reform of the financial sector the Commission does not believe at this time that the terms of criterion 5 have yet been fully met. The conditions under which capital is allocated by banks in China cannot be said to reflect international standards for prudential lending, and the costs of capital continue to be artificially lowered for many enterprises. China's ongoing reform provides a strong platform for addressing the problems raised here.

The decision to allow partially-foreign or private investment in state banks has introduced international management practices into the financial sector. However, international regulatory and corporate governance standards appear to be applied only selectively and the Chinese government continues to play a significant role in the banking and financial sector. The Central Bank continues to be the determining actor in setting of interest rates for lending banks are not fully permitted to determine interest rates based on customer creditworthiness and other business considerations.

Banks still tend to lend more capital to SOEs than their role in the national economy would justify. Recent measures by the Government to improve the credit rating capacity of banks are important developments. The measures to recapitalize some of the major commercial banks to address the problem of accumulated non-performing loans have apparently reduced the level of NPLs in these banks. However, it remains to be seen whether such recapitalisation measures are economically sound and sustainable over the long term. Should those measures be repeated it would be a source of concern. The fact that China is still in the early stages of implementation of its new Bankruptcy Law, that banks still face difficulties to recover outstanding claims and the relatively high level of sub-standard loans must leave doubt as to the sustainability of the current situation, particularly in the case of any general economic downturn.

⁵⁶"China Government Subsidies Survey" by Anne Stevenson-Yang, Twin Poplars LL, EU-China Trade Project, 2007

3. GENERAL CONCLUSIONS

China's economy is a modern and increasingly market-based system. There is evidence of clear progress under each of the four outstanding MES criteria – especially at the level of changes to Chinese law. However it is also the case, that distortions prevail despite Chinese efforts to reduce state interference in the management of the economy. These distortions directly or indirectly affect the domestic cost and price structures which are the primary considerations for the purpose of TDI investigations.

This evaluation of China's progress towards fulfilling the MES criteria has highlighted the following elements:

- Under Criterion 1, which concerns the general allocation of economic resources in the Chinese economy, there is clear evidence of continued state intervention which impacts significantly on production costs and prices. These include price fixing practices, utility price setting and subsidisation of manufacturing inputs, export restrictions of raw materials. These are fundamental factors in establishing normal value in the context of trade defence investigations. To meet the terms of this criterion it would be necessary for China to show that direct interference by authorities both at national and local level in price, trade related measures and rate setting has been discontinued.
- Under Criterion 3, which concerns the operation of transparent and non-discriminatory company law, the adoption of the new Accounting Law must be seen as an important and positive development. The focus should now be on demonstrating the effective implementation of this law. This is crucial because reliable and transparent accounting practices are central to TDI investigations. The agreement with the Chinese authorities to prepare an independent expert study to evaluate the implementation and determine whether a critical mass of good accounting practices exists in China is a positive development in this respect. The study is expected to be completed in the first half of 2009 and will contribute to future assessments of progress towards meeting the terms of the Criterion 3.
- Under Criterion 4, which concerns the effective operation of bankruptcy, monopoly and intellectual property law, the adoption and gradual implementation of the new Bankruptcy Law is assessed by this report to be a major step. The focus must now be on showing effective implementation of these new laws. Once the transition period from the old to the new bankruptcy standards is completed an evaluation will be needed to assess the effective implementation of the new laws. Under this criterion progress on IPR protection is assessed by the European Commission and most external observers to be limited, despite Chinese legislative measures to that effect. Further steps are needed to ensure the implementation of China's international obligations and its own laws. The European Commission seeks evidence of greater and more general IPR enforcement by Chinese courts and notably a significant reduction in the production and export of counterfeited goods by China, as measured by the volume of seized counterfeited goods of Chinese origin in Europe

- Under Criterion 5, relating to the existence of an independent financial sector in China, the European Commission remains concerned by continued restrictions on the fixing of interest rates by commercial banks. The current lending system in China still favours state-owned enterprises over private enterprises and commercial banks still lack an adequate capacity to evaluate the creditworthiness of clients. Progress also needs to be made in the area of bad debt and non-performing loans, which remains relatively high. These problems are directly relevant to trade defence investigations because credit provided to companies at non-commercial rates or rates which do not reflect genuine risk assessments must be regarded as an unfair distortion of true prices. China could make progress on this criterion by improving access to credit for private companies and ensuring that Chinese banks are seen to lend on genuine commercial terms.

The European Commission acknowledges the progress that has been made in China towards fulfilling the technical criteria for Market Economy Status in trade defence investigations. In almost all cases, China now has a legal framework that meets these criteria. The focus for this reason is now on the demonstration by China of the effective implementation of that law.

Although the assessment of the European Commission is that none of the four outstanding criteria for MES have at this time been met, the progress already made provides a clear platform for fulfilling these criteria. This report has suggested steps that the European Commission believe need to be taken by the Chinese authorities for the technical status of MES in trade defence investigations to be awarded. The European Commission remains strongly committed to achieving that goal. To that end, as well as working closely with China in existing dialogues, a similar stock-take on progress will be undertaken before summer 2009.

4. SOURCES OF INFORMATION

I) Information provided by the Chinese authorities

In the period since the discussion of the update report in July 2007 the following documents were provided by the Chinese authorities at the request of the competent Commission services:

- Letter by the Director General of MOFCOM of 18 November 2007 containing replies in Chinese to the questions sent to the Chinese authorities on 30 July 2007. The English translation of these replies was provided on 14 January 2008.
- An information booklet entitled "Introduction of China's Financial Reform" prepared by MOFCOM in collaboration with the People's Bank of China prepared for the 8th meeting of the EU-China MES Working Group which took place on 10 April 2008 in Beijing.
- Information provided orally at the last meeting of the MES Working Group of 10 April 2008 in Beijing.

- Letter by the Director General of MOFCOM of 6 May 2008 containing replies to a number of questions sent to the Chinese authorities on 17 March 2008.

II) Other External Sources

- Economic Survey of China (OECD – 2005)
- Finance and Development, Next Steps for China (IMF – 2005)
- Trade Policy Review (WT/TPR/S/161) – China (WTO – 2006)
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- Replies to the Wuestions posed by the EC regarding the New and Full Notification of China (WTO – G/SCM/Q2/CHN/25) (September 2007)
- UBS Investment Research (January 2008) "How to think about China?"
- UBS Investment Research (April 2008) "How long can energy subsidies last?"
- US International Trade Commission – "China: Description of Selected Government Practices and Policies Affecting Decision-Making in the Economy" – December 2007 (Investigation No. 332-442)
- "Banking Reform in China: Driven by International Standards and Chinese Specifics" by Zdenek Kudrna - October 2007 – Transformation, Integration and Globalization Economic Research Papers (No. 109)
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