

***EUROPEAN UNION – MEASURES RELATED  
TO PRICE COMPARISON METHODOLOGIES***

**(DS516)**

**THIRD PARTY SUBMISSION  
OF THE UNITED STATES OF AMERICA**

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Short Form	Full Citation
<i>China – Publications and Audiovisual Products (Panel)</i>	Panel Report, <i>China – Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products</i> , WT/DS363/R and Corr.1, adopted 19 January 2010, as modified by Appellate Body Report WT/DS363/AB/R
<i>China – Rare Earths (AB)</i>	Appellate Body Reports, <i>China – Measures Related to the Exportation of Rare Earths, Tungsten and Molybdenum</i> , WT/DS431/AB/R / WT/DS432/AB/R / WT/DS433/AB/R, adopted 29 August 2014
<i>EC – Fasteners (China) (AB)</i>	Appellate Body Report, <i>European Communities – Definitive Anti-Dumping Measures on Certain Iron or Steel Fasteners from China</i> , WT/DS397/AB/R, adopted 28 July 2011
<i>EC – Seal Products (AB)</i>	Appellate Body Reports, <i>European Communities – Measures Prohibiting the Importation and Marketing of Seal Products</i> , WT/DS400/AB/R / WT/DS401/AB/R, adopted 18 June 2014
<i>EU – Biodiesel (AB)</i>	Appellate Body Report, <i>European Union – Anti-Dumping Measures on Biodiesel from Argentina</i> , WT/DS473/AB/R and Add. 1, adopted 26 October 2016
<i>EU – Biodiesel (Panel)</i>	Panel Report, <i>European Union – Anti-Dumping Measures on Biodiesel from Argentina</i> , WT/DS473/R and Add. 1, circulated 29 March 2016
<i>US – 1916 Act (Japan) (Panel)</i>	Panel Report, <i>United States – Anti-Dumping Act of 1916, Complaint by Japan</i> , WT/DS162/R and Add.1, adopted 26 September 2000, upheld by Appellate Body Report WT/DS136/AB/R, WT/DS162/AB/R
<i>US – Anti-Dumping and Countervailing Duties (China) (AB)</i>	Appellate Body Report, <i>United States – Definitive Anti-Dumping and Countervailing Duties on Certain Products from China</i> , WT/DS379/AB/R, adopted 25 March 2011
<i>US – Shrimp II (Viet Nam)</i>	Panel Report, <i>United States – Anti-Dumping Measures on Certain Frozen Warmwater Shrimp from Viet Nam</i> , WT/DS429/R / and Add. 1, circulated 17 November 2014

### TABLE OF EXHIBITS

Exhibit No.	Description
USA-1	WTO Accessions Document: Review of Transition to Market-Based Economies by Acceding Non-Market Economy Countries (emphasis added to quoted materials)
USA-2	U.S. Department of Commerce, “China’s Status as a Non-Market Economy,” Docket A-570-053 (Oct. 27, 2017) (“ <i>DOC NME Report</i> ”)
USA-3	U.S. Department of Commerce, “Review of China’s Financial System Memorandum,” Docket C-570-054 (Aug. 1, 2017) (“ <i>DOC Financial System Report</i> ”)
USA-4	Alibaba Group Holding Ltd, Form F-1 (2014) Sinopec Form 20-F Filing (2016) China Pacific Insurance Group, Articles of Association, Article 8 PetroChina, Articles of Association, Article 105
USA-5	Multilateral Trade Negotiations: Anti-Dumping Duties (Circulated at the Request of Certain Developing Countries), MTN/INF/30 (June 30, 1978)
USA-6	Proposals by the Czechoslovak Delegation, W.9/86 (Dec. 9, 1954)
USA-7	Article VI – Draft Interpretative Note to Paragraph 1 Proposed by the Czechoslovak Delegation, Spec/93/55 (Feb. 7, 1955)
USA-8	Sub-Group III-A of Review Working Party III to Trade Other than Restrictions or Tariffs, W.9/220 (Feb. 22, 1955)
USA-9	Draft Report to the Contracting Parties, W.9/231 (Feb. 26, 1955)
USA-10	Report of Review Working Party III to Trade Other than Restrictions or Tariffs, L/334 (Mar. 1, 1955)
USA-11	Legal Drafting Committee: Drafting Changes, W.9/236/Add.1 (Mar. 3, 1955)
USA-12	Reports Relating to the Review of the Agreement: Other Barriers to Trade, BISD 3S/222 (Mar. 3, 1955)

<b>Exhibit No.</b>	<b>Description</b>
USA-13	Anti-dumping and Countervailing Duties: Secretariat Analysis of Legislation, L/712 (Oct. 23, 1957)
USA-14	Summary Record of the Fifteenth Meeting, SR.12/15 (Nov. 23, 1957)
USA-15	Report of the Group of Experts on Anti-Dumping and Countervailing Duties, L/978 (Apr. 24, 1959)
USA-16	Second Report of the Group of Experts on Anti-Dumping and Countervailing Duties, L/1141 (Jan. 29, 1960)
USA-17	GATT Working Party Report on the Accession of Poland, L/2806 (June 23, 1967)
USA-18	Protocol for the Accession of Poland to the GATT, BISD 15S/46
USA-19	GATT Working Party Report on the Accession of Romania, L/3557 (Aug. 5, 1971)
USA-20	Protocol for the Accession of Romania to the GATT, BISD 18S/7
USA-21	GATT Working Party Report on the Accession of Hungary, L/3889 (July 20, 1973)
USA-22	Protocol for the Accession of Hungary to the GATT, BISD 20S/3
USA-23	Working Party on China's Status as a Contracting Party, Spec(88)13 (Mar. 29, 1988)
USA-24	Statement of Administrative Action accompanying the Uruguay Round Agreements Act, H.R. Doc. No. 103-316, Vol. 1, p. 822
USA-25	Council Regulation (EC) No 1972/2002 amending Regulation (EC) No 384/96 on the protection against dumped imports from countries not members of the European Community (Nov. 5, 2002)
USA-26	Dictionary references
USA-27	Report of the Working Party on the Accession of the Russian Federation to the World Trade Organization, WT/ACC/RUS/70, WT/MIN(11)/2, para. 90 (Nov. 17, 2011)
USA-28	Constitution of the People's Republic of China (2004)

<b>Exhibit No.</b>	<b>Description</b>
USA-29	Report of the Working Party on the Accession of China, WT/ACC/CHN/49 (Oct. 1, 2001)
USA-30	Notification of Acceptance, Entry into Force, WT/LET/408 (Nov. 20, 2001)



## I. INTRODUCTION

1. China has fundamentally misunderstood the relevant text of the *Marrakesh Agreement Establishing the World Trade Organization* (“WTO Agreement”) as it relates to anti-dumping proceedings. There is no basis for China’s core assertion that domestic prices or costs that are not market-determined must be used for purposes of anti-dumping comparisons. To the contrary, WTO Members (and GATT Contracting Parties) have long understood that they have the authority to reject and replace such non-market prices or costs because an anti-dumping comparison requires comparable, market-determined prices or costs. Given that China’s legal understanding is fundamentally flawed, China’s claims that the EU’s Basic Regulation is inconsistent with Articles I and VI of the GATT 1994 and Articles 2.1 and 2.2 of the Anti-Dumping Agreement must fail. If China wishes for its producers’ or exporters’ prices or costs to be used in anti-dumping comparisons, China should complete its economic transition and ensure that market economy conditions prevail in its economy.

2. The multilateral trading system began 70 years ago when 23 nations signed the *General Agreements on Tariffs and Trade* (“GATT”). That system was designed by market economy countries to set limits on the actions they would take affecting trade with each other. In 2001, when China acceded to the WTO, China’s economy did not operate according to market economy principles. As was stated in the context of the review of the Working Party in relation to China’s interest in acceding to the GATT:

In the case of centrally-planned economies where sales and purchasing decisions were not based on real costs and that did not have price systems which reflected market forces, it was generally agreed that normal GATT obligations could not be undertaken. . . . In China’s case, these negotiations [for accession] were predicated on the conviction that China intended to alter the balance of market and non-market forces within its economy and to give thereby price-based market forces a prominent role in the decision driving trade.<sup>1</sup>

3. GATT and WTO commitments generally presuppose that each Member has or is developing a free market economy, and it was understood in 2001 that, following its accession to the WTO,<sup>2</sup> China would fully transition to an economy that would operate based on free market principles.

4. Sixteen years later, China still has not transitioned to an economy that operates based on market economy principles.<sup>3</sup> In bringing this dispute, China appears to believe that the economic conditions in its territory are irrelevant to the application of WTO rules. That is wrong; facts

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<sup>1</sup> Working Party on China’s Status as a Contracting Party, Spec(88)13 (Mar. 29, 1988), para. 2.12 (Exhibit USA-23).

<sup>2</sup> Protocol on the Accession of the People’s Republic of China, WT/L/432 (Nov. 23, 2001), Section 1, para. 3 (“China Accession Protocol”). China accepted the Protocol on November 11, 2001, and became a WTO Member on December 11, 2001. Notification of Acceptance, Entry into Force, WT/LET/408 (Nov. 20, 2001) (Exhibit USA-30).

<sup>3</sup> See Section III.C, *infra*.

matter. China does not argue that it is, today, a market economy country because the overwhelming evidence, and China's own statements, reveal that market economy conditions do not prevail in China. Nor can China demonstrate that its domestic prices or costs are determined under market economy conditions. China is subject to WTO rules and does not enjoy special rights and privileges not accorded any other Member under the WTO Agreement. Specifically, China does not have the right to engage in government interference and intervention in market mechanisms, distorting market outcomes and undermining WTO rules, without consequence.

5. With respect to anti-dumping rules, it was recognized soon after the GATT was established, and was reaffirmed repeatedly thereafter, that an importing country could apply anti-dumping duties to imports from a non-market economy. And the GATT Contracting Parties recognized that the dumping comparison under GATT 1994 Article VI:1 requires "comparable" prices or costs, in the ordinary course of trade – that is, market-determined prices or costs.

6. Specifically, in determining price comparability under Article VI of the GATT 1994, an importing Member may reject and replace domestic prices or costs in non-market economy countries with prices or costs determined under market economy conditions. This authority under Article VI is reflected in the legal text and in the consistent practice of GATT Contracting Parties and WTO Members spanning decades, including:

- the proposal to amend Article VI:1 and eventual adoption of the Second Note (1954-55), confirming this legal authority existed in Article VI;
- the Secretariat review of Contracting Parties' application of Article VI, demonstrating a subsequent, common practice rejecting non-market-determined prices or costs in determining normal value (1957);
- the Accessions to the GATT of three non-market economies – Poland (1967), Romania (1971), and Hungary (1973) – in which the CONTRACTING PARTIES affirmed their existing ability to reject non-market prices or costs in situations other than "the case" described in the Second Note;
- Article 2 of the Anti-Dumping Agreement (1995), bringing forward the key concepts from Article VI:1 and reinforcing (through terms such as "proper comparison") that market-determined prices or costs are necessary for anti-dumping comparisons; and
- Section 15 of China's Accession Protocol (2001), which clarifies that domestic prices or costs will be used when "market economy conditions prevail" for the industry under investigation, but domestic prices or costs may be rejected when market economy conditions do not prevail.

Therefore, Section 15 of China's Accession Protocol simply confirms and clarifies that in determining price comparability under Article VI of the GATT 1994 and the Anti-Dumping

Agreement, an importing Member may reject and replace Chinese prices or costs with prices or costs that are determined under market economy conditions.

7. WTO Members did not agree in China's Accession Protocol to set a time period after which market economy conditions would automatically be deemed to exist in China (or a Chinese industry or sector), no matter what the actual facts in China revealed. Nor did they agree that, notwithstanding evidence to the contrary, Chinese prices or costs would automatically be deemed to have been determined under market economy conditions. To do so now would grant China special rights and privileges under the anti-dumping rules that are not accorded any other WTO Member. Specifically, it would grant China the right to require Members to forgo an examination of whether domestic prices or costs in China are "comparable prices, in the ordinary course of trade," under Article VI of the GATT 1994 and the Anti-Dumping Agreement even though market economy conditions do not prevail in China generally, or in the Chinese sector or industry producing the like product.

8. Through this dispute, and the erroneous legal interpretation underlying China's claims, China is seeking to upset the balance of rights and obligations in the WTO Agreement – a balance that was critical to the decision of existing Members to permit China to accede. When China was admitted to the WTO, Members agreed to extend certain benefits to China – for example, to apply duties no higher than their tariff bindings. But, as the legal interpretation attached to this submission as Attachment 1 demonstrates, Members did not agree to give up their right to impose anti-dumping duties consistent with Article VI of the GATT 1994 and the Anti-Dumping Agreement, including by rejecting and replacing prices or costs that are not determined under market economy conditions for purposes of anti-dumping comparisons. Members also admitted China to the WTO with the expectation that China would carry out its stated intention to fully transition to a market economy within 15 years. But 16 years later, it is demonstrably clear that China has not completed that transition. Nonetheless, China now seeks to deprive other Members of their WTO rights in relation to the investigation and application of anti-dumping duties.

9. This is not the agreement reflected in the text of the WTO Agreement; it was not the intention of the parties; and this result cannot be imposed after-the-fact through dispute settlement. Recommendations of the DSB cannot add to or diminish the rights and obligations of WTO Members. If China wishes to terminate, in the future, the right of WTO Members to reject and replace non-market prices or costs for anti-dumping comparisons, it may make such a proposal to the Membership and attempt to negotiate such a result. But if China wishes, today, for Members to use its domestic prices or costs for anti-dumping comparisons, China must demonstrate that market economy conditions prevail in its economy or the relevant industry or sector.

## **II. STRUCTURE OF THE SUBMISSION**

10. China remains today a non-market economy, and if market economy conditions do not prevail in China generally, or in the Chinese sector or industry producing the like product with

regard to the manufacture, production, and sale of that product, an importing WTO Member may reject and replace such non-market prices or costs for purposes of establishing normal value for anti-dumping comparisons. As stated in Section 15 of China's Accession Protocol, a Member may, in determining price comparability under Article VI of the GATT 1994 and the Anti-Dumping Agreement, "use a methodology that is not based on a strict comparison with domestic prices or costs in China." In this third-party submission, the United States demonstrates that the use of such a methodology does not breach Articles I of the GATT 1994, nor does such use violate Article VI of the GATT 1994 or the Anti-Dumping Agreement.

11. In Section III, the United States explains why it is significant that market economy conditions do not exist in China, more than 15 years after China acceded to the WTO. Section III.A addresses why market economy conditions matter to the multilateral trading system. GATT commitments, brought forward into the WTO, were crafted by parties that were market economies to provide reciprocal benefits to other parties and their economic actors; such commitments can be easily evaded, and the benefits of other parties diminished, where a government intervenes in its economy and influences specific economic outcomes. Section III.A demonstrates that the critical importance of transitioning to a market economy has been repeatedly recognized in the accessions of other non-market economies to the WTO. Section III.B then briefly reviews China's accession to the WTO and shows that negotiations of with the accession commitments reflected the expectation that China, following accession, would continue its transition from a non-market economy to a free market economy. Finally, in Section III.C, we examine the economic system in China today to demonstrate that the Chinese government continues to maintain and exercise broad discretion and control to allocate resources with the goal of achieving specific economic outcomes. This system distorts costs and prices throughout China's economy, such that non-market conditions continue to prevail in the operation of China's economy. The extensive distortions in China's economy affect world markets in a variety of ways. China's position in this dispute – that Members are prohibited from rejecting and replacing prices or costs that are not determined under market economy conditions for purposes of anti-dumping comparisons – would further expose other Members to those economic distortions by preventing them from addressing their negative effects through anti-dumping duties where appropriate.

12. In Section IV, the United States summarizes and addresses the proper understanding of the relevant legal texts governing anti-dumping comparisons. In particular, exploring the obscure phrase "in determining price comparability," one finds that WTO Members and GATT Contracting Parties have always recognized that an anti-dumping comparison requires comparable, market-determined prices or costs. As we explain in detail in the legal interpretation set out as Attachment 1 to this submission, the evidence is overwhelming that WTO Members have not surrendered their longstanding rights in the GATT and WTO to reject prices or costs that are not determined under market economy conditions in determining price comparability for purposes of anti-dumping comparisons.

13. In Section V, the United States applies this proper understanding of the relevant legal texts to demonstrate that China has failed to make out its claims. In Section V.A, we demonstrate that the measure at issue does not breach Articles 2.1 or 2.2 of the Anti-Dumping Agreement, or Article VI:1 of the GATT 1994. China’s legal claims cannot be reconciled with the text of the relevant agreements that establish and confirm that an anti-dumping comparison requires comparable, market-determined prices or costs. By asserting that Chinese prices or costs must be used for anti-dumping comparisons, China takes the position that an importing Member must ignore the economic facts, but there is no basis for this view in the WTO Agreement. In Section V.B, we demonstrate that China has failed to establish its claim under Article I of the GATT 1994 because it does not attempt to establish any inconsistency with WTO provisions dealing specifically with the application of anti-dumping duties. Based on this demonstration, the Panel need not examine China’s Article I:1 claim further. But the United States nonetheless goes on to show that the measure at issue does not breach Article I:1 because China has not shown that the prices or costs of its producers or exporters are market-determined, and that they are not accorded any advantage, favor, privilege or immunity accorded to the market-determined prices or costs of imports from other WTO Members.

**III. IT IS SIGNIFICANT THAT CHINA IS A NON-MARKET ECONOMY BECAUSE RECIPROCAL GATT AND WTO COMMITMENTS CAN BE DIMINISHED AND COMMITMENTS EVADED WHERE AN ECONOMY OPERATES PURSUANT TO GOVERNMENT DIRECTIVES**

14. GATT commitments, brought forward into the WTO, were crafted by parties that were market economies to provide reciprocal benefits to other parties and their economic actors.<sup>4</sup> Not surprisingly, those commitments presuppose that a party has or is developing a free-market economy.<sup>5</sup> For example, Members committed generally to use transaction value for customs

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<sup>4</sup> GATT 1994, Preamble:

*Recognizing* that their relations in the field of trade and economic endeavour should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, and expanding the production and exchange of goods and services, . . .

\* \* \*

*Being desirous* of contributing to these objectives by entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international relations, . . . .

<sup>5</sup> See, e.g., W. Zdouc, “Comments,” in STATE TRADING IN THE TWENTY-FIRST CENTURY, Ch. 7 (Cottier and Mavroidis eds. 1998), p. 151 (“GATT’s legal system presupposes a market economy and may be circumvented in a situation where governments intervene systematically in the market place.”); J. Jackson, THE WORLD TRADING SYSTEM, (2d ed. 1997), p. 325 (“The post-World War II international trading system is obviously based on rules and principles that more or less assume free market-oriented economies. The rules of GATT certainly were constructed with that in mind.” (footnote omitted)); J.F. Beseler and A.N. Williams, ANTI-DUMPING AND ANTI-SUBSIDY LAW: THE EUROPEAN COMMUNITIES (1986), p. 64 (“The emphasis on transactions in the ordinary course of trade in the

purposes, understood to be the price at which merchandise is sold or offered for sale in the ordinary course of trade under fully competitive conditions.<sup>6</sup> Such benefits can be diminished by an economy in which the government intervenes and influences specific economic outcomes. If a Member's economy operates pursuant to government directives, as opposed to free market principles, the basic rules on non-discrimination, market access, and fair trading can be easily evaded.<sup>7</sup>

15. The issue of how a non-market economy may accede to the GATT / WTO and take on GATT / WTO obligations was critically important in the context of China's proposed accession, given China's size and potential impact on the world trading system. When this issue was examined in light of GATT principles, it was observed during the negotiations for China's accession to the WTO that:

GATT provisions were based on the assumption that import and export flows were responsive to price changes and that importers and exporters were free to make commercial decisions based on price criteria. When a market-economy country undertook GATT obligations, it was believed that adherence to GATT Articles would improve the climate surrounding trade decisions and result in an actual improvement in the level of market access for imports and in export flows based on comparative advantage. *In the case of centrally-planned economies where sales and purchasing decisions were not based on real costs and that did not have price systems which reflected market forces, it was generally agreed that normal GATT obligations could not be undertaken. More accurately, under these circumstances, technical adherence to GATT Articles would not, in and of itself, affect the basis upon which trade decisions were made and therefore not actually increase market access or discipline export practices.* Experience had shown that even if elements of centrally-planned systems could absorb significant market-oriented reforms, the nature of the system would continue to impede the operation of GATT Articles that ensured market access, i.e., to limit or negate the balance of rights and obligations contained in the Articles.<sup>8</sup>

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definition of dumping makes clear that the GATT presumes the existence of free and open markets where prices are determined by supply and demand under normal competitive conditions.”).

<sup>6</sup> GATT 1994 Article VII:2(a), (b).

<sup>7</sup> See W. Davey, “Article XVII GATT: An Overview,” in STATE TRADING IN THE TWENTY-FIRST CENTURY, Ch. 1 (Cottier and Mavroidis eds. 1998), pp. 21-22 (“In essence, GATT needs special rules on state trading enterprises because GATT rules often assume the existence of a market-based economy where enterprise make decisions on the basis of economic factors, not government directives. If one examines the basic GATT rules on non-discrimination, market access, and fair trade, it is clear that evasion of those rules would be easily possible if there were no controls on state trading enterprises” (footnote omitted)). Although the author is discussing state-trading enterprises, he notes that the discussion of the ability of state-trading enterprises to evade basic GATT rules applies equally to countries with non-market economies. See *ibid.*, p. 32.

<sup>8</sup> Spec(88)13 (Mar. 29, 1988), para. 2.12 (emphasis added) (Exhibit USA-23).

16. Since the commitments and rules of the WTO are written from a presumption that WTO Members have market economies, it was understood that a non-market economy country, before it could accede to the WTO, would need to demonstrate that it had transitioned, or planned to transition, from a non-market to a free market economy to ensure the effective implementation of WTO obligations.

**A. Negotiations by Non-Market Economies for Accession to the WTO Confirm the Importance of Transitioning to a Free Market Economy**

17. The importance of an acceding party's transition to a market economy, in circumstances in which it did not already have such a free market economy, is evident in reviewing the historical record of WTO accessions. Below is a sample of statements from Exhibit USA-1, which summarizes some of the documents related to the WTO accession negotiations between non-market economy countries and the existing WTO Membership. It is clear from these statements that the negotiations associated with WTO accession as they relate to non-market economies generally – not just China – focused in part on whether the country in question had transitioned, or was in the process of transitioning, from a non-market economy to a free market economy:

- Poland (accession 1 Jan. 1995): “During the course of its renegotiation of the terms of its accession to GATT, Poland indicated that as of January 1, 1990, *a set of laws and regulations entered into force that established an open market in Poland*. Poland noted that as a result of the ongoing changes in its economic and foreign trade system, many provisions in its accession protocol had become inadequate. As such, it recognized that there is a need to adapt the accession protocol to the market character of the Polish economy. Such a move ‘would assist the Solidarity-led Government of Poland in its great efforts to build a liberal, efficient and open economy, well integrated into the multilateral trading system.’”<sup>9</sup>
- Hungary (accession 1 Jan. 1995): “At the special session of the GATT Council conducting the review of Hungary (C/RM/M/11), the Chairman noted in his concluding remarks, *inter alia*, that: . . . ‘The Council expressed its strong appreciation and support for *Hungary’s efforts to establish a market economy* and the considerable liberalization steps already taken. New measures and policies had recently been introduced, or announced, by the Hungarian Government to accelerate and intensify the reform process. Hungary’s determination to pursue these reforms was particularly noteworthy in the view

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<sup>9</sup> Exhibit USA-1, p. 42 (italics added). Although Poland was already a GATT Contracting Party, the Polish Government requested that the terms of accession be renegotiated because of the “clear need for changing the provisions in question in order to adapt the Protocol to the market character of the Polish economy.” L/6634(12/01/1990), p. 1.

of the profound structural changes required and major problems of economic and monetary imbalances which had to be addressed.”<sup>10</sup>

- Czech Republic and Slovak Republic (accession 1 Jan. 1995): “Czechoslovakia is undergoing profound and important economic and social changes and embarking on fundamental reform to stimulate economic growth through increasing productivity and better allocation of resources. *This reform involves systemic change which will result in the establishment of a competitive market, de-monopolization, indirect approaches to macro-economic management, liberalization of trade and greater integration in the international economy.*”<sup>11</sup>
- Romania (accession 1 Jan. 1995): “Romania has adopted fundamental legislative measures under the Programme of Economic Reform for the *transition to the market economy*. A more liberal economic system has been established: *central planning was abolished . . .*”<sup>12</sup>
- Slovenia (accession 30 July 1995): “The Government of Slovenia intends to implement the following economic program in 1992: *Transformation of the economic system and the system of social ownership into an economic system of private ownership.*”<sup>13</sup>
- Bulgaria (accession 1 Dec. 1996): “Since February 1991 the Government has started implementing the first stage of the economic reform through which the *basic elements of the market economy were introduced and State intervention in the economic activity of companies was abolished.*”<sup>14</sup>
- Mongolia (accession 29 Jan. 1997): “The Government recognizes that, in order to expand trade through obtaining new markets and sources of supply, *the participation in foreign trade by the private sector must be promoted actively in a market-oriented environment*. And it has initiated a policy of decentralizing foreign trade activities by

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<sup>10</sup> Exhibit USA-1, p. 30 (italics added). Although Hungary was already a GATT Contracting Party, the Hungarian Government requested that the terms of accession be renegotiated because of “substantial changes in the Hungarian economy.” L/6909 (26/09/1991), p. 2.

<sup>11</sup> Exhibit USA-1, p. 23 (italics added). Although Czechoslovakia was already a GATT Contracting Party, the Government of the Czech and Slovak Federal Republic requested that the terms of accession be renegotiated because of “the fundamental reform of the CSFR economic régime, in particular the transformation from a centrally-planned to a market economy.” L/6911 (27/09/1991), p. 1.

<sup>12</sup> Exhibit USA-1, p. 43 (italics added). Although Romania, was already a GATT Contracting Party, the Romanian Government requested that the terms of accession be renegotiated: “Having in view the steps undertaken in the process of transition to a liberal and open economy, based on market principles and rules, the Protocol of Accession of Romania to the GATT, concluded when Romania had a centrally-planned economy, has become outdated.” L/6891 (06/02/1992), p. 1.

<sup>13</sup> Exhibit USA-1, p. 48 (italics added).

<sup>14</sup> Exhibit USA-1, p. 18 (italics added).



issuing trade licences to private and public enterprises other than the State FTOs engaged in direct production activities.”<sup>15</sup>

- Kyrgyz Republic (accession 20 Dec. 1998): “Since independence, the Kyrgyz Republic has *steadily and consistently pursued its major economic objective of transforming its centrally planned economy into a market economy.*”<sup>16</sup>
- Latvia (accession 10 Feb. 1999): “On 17 September 1991, the General Assembly of the United Nations voted to accept Latvia as a member. Since that time, the country has experienced sweeping social, political and economic changes. *These changes are oriented towards the establishment of a market economy* and a democratic polity, in fact this period has seen a discernable strengthening of the country's democratic stabilization elements - the multiparty political system, the active and freely elected parliament, the independent court structures, the free and independent mass media, and the *market-oriented macroeconomic stabilization.*”<sup>17</sup>
- Estonia (accession 13 Nov. 1999): “On 20 August 1991, Estonia regained its independence and was faced with the massive task of transforming itself both politically and economically. Now, only two years later, Estonia is a democracy that is well on the way to *developing a free market economy in which the play of competitive market forces determines prices.*”<sup>18</sup>
- Georgia (accession 14 June 2000): “Considerable economic change has taken place and the Georgian economy has changed substantially since independence. . . . The main objectives of Georgia are to maintain political and economic stabilization, *accelerate the transition to a market economy*, promote economic growth and improve social welfare. The Government believes that these objectives can only be attained through full integration into the world economy and the pursuit of open trade policies. . . . The Government of Georgia considers its accession to the World Trade Organization one of the most important steps toward integration into the world economy.”<sup>19</sup>
- Albania (accession 8 Sept. 2000): “The Parliament and the Government of Albania have made substantial progress in establishing a legal framework to support the *transition from*

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<sup>15</sup> Exhibit USA-1, p. 40 (italics added).

<sup>16</sup> Exhibit USA-1, p. 32 (italics added).

<sup>17</sup> Exhibit USA-1, p. 34 (italics added).

<sup>18</sup> Exhibit USA-1, p. 25 (italics added).

<sup>19</sup> Exhibit USA-1, p. 27 (italics added).

*a centralized, controlled economy to an economic system based on free market principles.*<sup>20</sup>

- Croatia (accession 30 Nov. 2000): “The activities of the state, in the context of the economic development strategy of Croatia as a small and open economy in transition, are aimed at constructing legal and institutional prerequisites for normal functioning of the market economy with predominant private ownership, ensuring favourable macroeconomic conditions such as internal and external balance and the development of mechanisms for structural adjustment in the financial and real sectors of the economy.”<sup>21</sup>
- Lithuania (accession 21 May 2001): “The transformation from a centrally planned economy to a free market economy began in March 1990 as soon as the Republic of Lithuania gained independence.”<sup>22</sup>
- Republic of Moldova (accession 26 July 2001): “Moldova is a country in transition whose economy is undergoing a process of structural adjustment in order to correct an excessive dependence on primary production. In a relatively short period of time a basic framework of a market economy has been established and macro-economic stabilisation achieved.”<sup>23</sup>
- Armenia (accession 5 Feb. 2003): “The transition of the Armenian economy from a system in which all prices were administered to one in which market forces determine prices is almost complete.”<sup>24</sup>
- The former Yugoslav Republic of Macedonia (accession 4 April 2003): “In the period of transition, the major priorities of the economic development are: establishment of the economic system and institutions imminent to systems in countries with market economy; opening of the wide process of privatisation of the social property, stabilisation of the economic trends with short-term perspectives for balancing the aggregate supply and demand and the cutting down of inflation by resolving balance of payments problems on the medium-term basis, gradual resolution of internal fiscal and quasi-fiscal deficits and accomplishment of the full financial discipline.”<sup>25</sup>

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<sup>20</sup> Exhibit USA-1, p. 1 (italics added).

<sup>21</sup> Exhibit USA-1, p. 21 (italics added).

<sup>22</sup> Exhibit USA-1, p. 35 (italics added).

<sup>23</sup> Exhibit USA-1, p. 38.

<sup>24</sup> Exhibit USA-1, p. 6 (italics added).

<sup>25</sup> Exhibit USA-1, p. 37 (italics added).

- Cambodia (accession 13 Oct. 2004): “Since the signing of the Paris Peace Accord in 1991, the reform process has been deepened and widened significantly to the point that *the country is now operating a market economy system.*”<sup>26</sup>
- Viet Nam (accession 11 Jan. 2007): “The State of Vietnam *departed the centrally planned economic system to shift towards a market-based one*, in which recognition and encouragement have been given to all economic sectors with a view to developing and improving its legal, socio-economic environments, which in turn would serve as an impetus to involve all economic sectors and every citizen into the socio-economic construction and development.”<sup>27</sup>
- Ukraine (accession 16 May 2008): “The strategic goal of the economic policy of Ukrainian Government is *the creation of market economy in Ukraine* which would promote economic wealth of all citizens of Ukraine. More specifically, Ukraine seeks to establish a stable monetary-financial system, implement denationalization and privatization of industrial enterprises and respective infrastructure, create conditions for the restoration of private property in the agricultural sector for the purpose of achieving required efficiency of privatized entities, and creation of system of self-regulating market relations being the basis for qualitative and structural changes in the economy, to reform the legislation and administrative-legal system in line with the above goal, and *standards and principles of the market economy.*”<sup>28</sup>
- The Russian Federation (accession 22 Aug. 2012): “*The transition of the Russian economy from central planning to market principles* has been a significant historic event in the final decade of the twentieth century. Starting in November 1991, *radical reforms have been made to the economic structure of the Russian Federation with the aim of transforming the economy into a market economy and promoting the full integration of Russia into the international trading system.*”<sup>29</sup>
- Lao People’s Democratic Republic (accession 2 Feb. 2013): “In 1986, the Government of the Lao PDR adopted the New Economic Mechanism. This initiated a program of economic reform with the goal of stabilizing the economy and increasing growth by *shifting from a centrally planned economy to a market oriented economy.*”<sup>30</sup>
- Tajikistan (accession 2 March 2013): “*Since its independence Tajikistan started fundamental social and economic reforms and transition to market-oriented economy.* Already at the first stage of transition the Government of the country started partially

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<sup>26</sup> Exhibit USA-1, p. 19 (italics added).

<sup>27</sup> Exhibit USA-1, p. 65 (italics added).

<sup>28</sup> Exhibit USA-1, p. 54 (italics added).

<sup>29</sup> Exhibit USA-1, p. 44 (italics added).

<sup>30</sup> Exhibit USA-1, p. 33 (italics added).

using an economic policy called “Shock therapy”. First, liberalization of prices with simultaneous suspension of subsidies for producers and consumers was carried out. In order to contain the inflation pressure evolved as a result of these measures, stabilization monetary policy was conducted which would limit money supply and reduce state expenditures for decreasing the state budget deficit. Simultaneously liberalization of foreign currency markets was carried out which represented in a way privatization policy and *the whole process was coming to the end by measures on structural reorganization aimed at creation of the basis for future market-oriented economy.*”<sup>31</sup>

- Kazakhstan (accession 30 Nov. 2015): “Since independence in 1991, Kazakhstan has been undergoing *a comprehensive economic reform toward an open, free and competitive market economy*. During the past two years, significant progress has been achieved in many areas including trade liberalization, privatization of the economy, development of competition in many sectors, inflation control, monetary and fiscal reform, price liberalization, financial sector reform, legal and regulatory reform, institutional reform and the establishment of a conducive environment for trade and investment. Accordingly, *government interference in the market has been significantly reduced.*”<sup>32</sup>
- Azerbaijan (accession in progress): “The resumption of economic growth accompanied by a rapid expansion of foreign trade has prompted the Government of Azerbaijan to seek membership in the WTO. The objective of the Government’s strategy is reintegration of Azerbaijan’s economy into international markets. The measures for liberalisation, related to the *transition of Azerbaijan to a market economy*, were the reasons for the establishment of the competitive environment.”<sup>33</sup>
- Belarus (accession in progress): “Since independence, *the focus of economic policy in Belarus has been on transforming the former central planning system into a market economy.*”<sup>34</sup>
- Bosnia and Herzegovina (accession in progress): “The Governments at the State and Entity levels have made *a clear political commitment to base the future of the country on economic reforms, including privatization, market economy transition . . . .* The WTO membership will also accelerate structural reforms necessary for the transition to a market-based economy and the creation of a liberal and open foreign trade system.”<sup>35</sup>

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<sup>31</sup> Exhibit USA-1, p. 51 (italics added).

<sup>32</sup> Exhibit USA-1, p. 31 (italics added).

<sup>33</sup> Exhibit USA-1, p. 10 (italics added).

<sup>34</sup> Exhibit USA-1, p. 12 (italics added).

<sup>35</sup> Exhibit USA-1, p. 14 (italics added).

- Serbia (accession in progress): “The main goals of Serbia’s medium term economic program are to become a WTO member and integrated into the European Union and the international economy, and to achieve a moderate economic growth. *To this end, Serbia will continue with political, legal, legislative and institutional reforms in support of the transition to a market economy, and WTO and EU Accession.*”<sup>36</sup>
- Uzbekistan (accession in progress): “Since independence, the Government has steadily followed its major economic objective of a *gradual transformation of the centrally planned economy inherited from the former Soviet Union into a socially-oriented market economy.*”<sup>37</sup>

18. These statements confirm the importance of an acceding party’s transition to a market economy to ensure that it and existing WTO Members fully benefit from reciprocal and mutually advantageous commitments.<sup>38</sup> The same expectation existed that China would transition from a non-market economy to a market economy.

**B. Negotiations Related to China’s Accession to the WTO Confirm that, Following Accession, China Would Continue the Process of Transitioning to a Market Economy**

19. Soon after China asked to “resume” its status as a contracting party to the GATT, several members of the Working Party made it known “that the first task of the Working Party was to examine carefully China’s economic system in the light of GATT principles.”<sup>39</sup>

20. One member “accepted China’s assurances that it was committed to increasing the market-orientation of its economy and trading system, to decentralizing its management and to introducing a pricing system that reflected supply and demand.”<sup>40</sup> This member indicated, however, that “[i]t was not known . . . at what pace these changes would actually take place or how effective they would be in creating a more market-oriented system. These were important questions for the GATT since, to a large extent, *the contracting parties’ confidence that China could accept and fulfil its GATT obligations depended upon the success of China’s economic reforms.*”<sup>41</sup> The member added:

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<sup>36</sup> Exhibit USA-1, p. 45 (italics added).

<sup>37</sup> Exhibit USA-1, p. 62 (italics added).

<sup>38</sup> See WTO Agreement, Preamble, fourth paragraph (“*Being desirous of contributing to these objectives by entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international trade relations*”).

<sup>39</sup> Spec(88)13 (Mar. 29, 1988), para. 2.9 (Exhibit USA-23).

<sup>40</sup> Spec(88)13 (Mar. 29, 1988), para. 2.11 (Exhibit USA-23).

<sup>41</sup> Spec(88)13 (Mar. 29, 1988), para. 2.11 (emphasis added) (Exhibit USA-23).

In previous accessions to the GATT by socialist, centrally-planned or non-market economy countries, the contracting parties had recognized the inability of such economies to respond to GATT provisions by negotiating special commitments in the accession protocols or insisting on lengthy provisional periods prior to full accession. *In China's case, these negotiations were predicated on the conviction that China intended to alter the balance of market and non-market forces within its economy and to give thereby price-based market forces a prominent role in the decisions driving trade.* For this reason, a key aspect of the examination in the Working Party had to be the extent to which China's economic reform process had been, or had not been, implemented and what contracting parties could expect in the future. It was necessary to find ways for the contracting parties to address not only those aspects of China's current trade regime that were inconsistent with GATT provisions but also those aspects of China's trade and economic system that precluded market access, market prices and fair trade practices.<sup>42</sup>

21. Another member “noted that there were at present no economic mechanisms [in China] ensuring that the pricing of goods for sale in the home market or in export markets corresponded to market forces. There was in particular no mechanism ensuring that exports were priced at levels which were profitable and not causing disturbance. . . . The contracting parties had to be able to defend themselves against any injurious effects resulting from these elements in the Chinese system.”<sup>43</sup>

22. The negotiations for China's accession to the WTO took almost 15 years, and the concerns about whether China could fulfill its GATT obligations remained throughout those negotiations, along with the expectation that China, once it joined the WTO, would continue its transition into a free market economy. Specifically, the final WTO Working Party Report on China's Accession stated with respect to anti-dumping and subsidies:

Several members of the Working Party noted that China was continuing the process of transition towards a full market economy. Those members noted that under those circumstances, in the case of imports of Chinese origin into a WTO Member, special difficulties could exist in determining cost and price comparability in the context of anti-dumping investigations and countervailing duty investigations.<sup>44</sup>

Therefore, that China's economy today continues to operate as one in which market economy conditions do not prevail undermines the reciprocal and mutually advantageous nature of WTO commitments and has particular consequences for anti-dumping comparisons and the application

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<sup>42</sup> Spec(88)13 (Mar. 29, 1988), para. 2.12 (emphasis added) (Exhibit USA-23).

<sup>43</sup> Spec(88)13 (Mar. 29, 1988), para. 2.21 (Exhibit USA-23).

<sup>44</sup> Report of the Working Party on the Accession of China, WT/ACC/CHN (Oct. 1, 2001), para. 150 (Exhibit USA-30).

of anti-dumping duties to Chinese imports.

### **C. China Still Has Not Transitioned to a Free Market Economy Today**

23. China's economy continues to operate as one in which market conditions do not prevail. The nature of China's economy is recognized as such in a multitude of fora. China's leading state-run companies routinely acknowledge the stark contrast between China's economic structure and those of free market countries. In a recent corporate disclosure, for example, China's own Sinopec (oil refining and petrochemicals) explained to shareholders that the "Chinese economy differs from the economies of most developed countries in many respects, including the amount of government involvement . . . and allocation of resources."<sup>45</sup> The material facts that Sinopec disclosed included its view that "the Chinese government continues to play a significant role in regulating industry development by imposing industrial policies" and that it "exercises significant control over China's economic growth through allocating resources . . . and providing preferential treatment to particular industries or companies."<sup>46</sup> Sinopec made these statements in the context of a corporate disclosure before the U.S. Securities and Exchange Commission – a disclosure in which misstatements or omissions of material fact are legally actionable and punishable by law.

24. China's most prominent enterprises, state-invested *and* non-state invested, attest to the fundamental non-market nature of the Chinese economy today. For example, Alibaba in its filings before the U.S. Securities and Exchange Commission has stated as follows:

The PRC economy differs from the economies of most developed countries in many respects, including the extent of government involvement, level of development, growth rate, control of foreign exchange and allocation of resources. Although the PRC government has implemented measures emphasizing the utilization of market forces for economic reform, the reduction of state ownership of productive assets, and the establishment of improved corporate governance in business enterprises, a substantial portion of productive assets in China is still owned by the government. In addition, the PRC government continues to play a significant role in regulating industry development by imposing industrial policies. The PRC government also exercises significant control over China's economic growth by allocating resources, controlling payment of foreign currency-denominated obligations, setting monetary policy, regulating financial services and institutions and providing preferential treatment to particular industries or companies.<sup>47</sup>

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<sup>45</sup> Exhibit USA-4, p. 7 (Sinopec Form 20-F Filing with the U.S. Securities and Exchange Commission (2016)).

<sup>46</sup> Exhibit USA-4, p. 7 (Sinopec Form 20-F Filing with the U.S. Securities and Exchange Commission (2016)).

<sup>47</sup> Exhibit USA-4, p. 43 (Alibaba Form F-1 Filing with the U.S. Securities and Exchange Commission (2014)).

25. These statements are indicative of the broad consensus that China remains today a non-market economy. In October 2017, the U.S. Department of Commerce completed an inquiry into whether China should continue to be treated as a non-market economy country under the U.S. anti-dumping and countervailing duty laws and confirmed that China “does not operate sufficiently on market principles to permit the use of Chinese prices and costs for purposes of the Department’s antidumping analysis.”<sup>48</sup> In the discussion that follows, the United States draws on that report to illustrate what it means to say that China is a non-market economy.

### **1. Key framework and institutions of State control in China’s economy**

26. The framework of China’s economy is set by the Chinese government and the Chinese Communist Party (CCP), which exercise substantial influence and control directly and indirectly over the allocation of resources through instruments such as government ownership and control of key economic actors and government directives. The stated fundamental objective of the government and the CCP is to uphold the “socialist market economy” in which the Chinese government and the CCP direct and channel economic actors to meet the targets of state planning. State-invested enterprises dominate strategic economic sectors and are one of the key institutions that the government and CCP rely upon to steer China’s economy.

#### **a. Political and legal mandate for state control of the economy**

27. The Chinese government has a legal and political mandate to maintain and uphold the “socialist market economy,” which at its core includes “maintaining a leading role for the state sector” in the economy. The guiding principles for government ownership and control are set forth in China’s *Constitution* and the *Constitution of the Chinese Communist Party* (“*CCP Constitution*”).

28. China’s *Constitution* provides a clear mandate for government ownership and control over the economy. Article 7 provides that “[t]he state-owned economy, that is, the socialist economy with ownership by the whole people, is the leading force in the national economy. The state ensures the consolidation and growth of the state-owned economy.”<sup>49</sup> Article 11 also provides that “[t]he state permits the private sector of the economy to exist and develop within the limits prescribed by law. The private sector of the economy is an important component of the socialist market economy.”<sup>50</sup> Article 11 states that “[t]he state *encourages, supports, and guides* the development of the non-public sectors of the economy.”<sup>51</sup> In other words, the state is

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<sup>48</sup> U.S. Department of Commerce, “China’s Status as a Non-Market Economy,” Docket A-570-53, p. 7 (Oct. 27, 2017) (“*DOC NME Report*”) (Exhibit USA-2).

<sup>49</sup> *DOC NME Report*, p. 53 (referencing China’s *Constitution*, Article 7) (Exhibit USA-2).

<sup>50</sup> *DOC NME Report*, p. 53 (referencing China’s *Constitution*, Article 11) (Exhibit USA-2).

<sup>51</sup> *DOC NME Report*, p. 53 (referencing China’s *Constitution*, Article 11) (emphasis DOC) (Exhibit USA-2).



to take active steps to ensure the growth of the state-owned economy as the core of the economic system and it will also intervene in the private sector, a component of the overall economy.

29. China's *Constitution* sets out a central role for the Chinese Communist Party to ensure a certain outcome with respect to the overall structure and direction of the economy. The *CCP Constitution* states: “[T]he Party must uphold and improve the basic economic system, with public ownership playing a dominant role and different economic sectors developing side by side.”<sup>52</sup> Accordingly, CCP members and the leadership have a mandate to ensure the dominance of the state and the state enterprise in the economy.

30. Core legislation setting forth China's economic system reflects these same principles. For example, Article 1 of the *Property Law of the People's Republic of China* (“*Property Law*”) makes clear that the law's purpose includes “safeguarding the basic economic system of the state,” and “maintaining the socialist market order.”<sup>53</sup> Article 1 of the *Company Law of the People's Republic of China* (“*Company Law*”), similar to Article 1 of the *Property Law*, states that the law is enacted for the purposes of, among other reasons, “promoting the development of the socialist market economy.”<sup>54</sup> The *Law of the People's Republic of China on the State-Owned Assets of Enterprises*, which applies to all enterprises with any level of state investment, affirms the role of the state as the overseer, participant, and ultimate decision-maker in preserving the leading role of the state sector.<sup>55</sup>

31. These laws and related measures affect the entire economy either directly, through the regulation of the state-invested entity (SIE)<sup>56</sup> sector, or indirectly, by establishing the context for the private sector's relationship with the SIE sector.<sup>57</sup>

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<sup>52</sup> *DOC NME Report*, pp. 52-55 (referencing *CCP Constitution*, Preamble) (emphasis DOC) (Exhibit USA-2).

<sup>53</sup> See *DOC NME Report*, pp. 52-55 (referencing *Property Law of the People's Republic of China*, Article 1 (adopted by NPC on March 16, 2007, Order No. 62, promulgated March 16, 2007) (Exhibit USA-2). Article 3 of the *Property Law* states that “[i]n the primary stage of socialism, the state upholds the basic economic system under which the public (state) ownership shall play a dominant role and diversified forms of ownership may develop side by side. The state consolidates and develops the public (state) economy, and encourages, supports and guides the development of the nonpublic economy.” *Ibid.*

<sup>54</sup> See *DOC NME Report*, p. 54 (referencing *Company Law of the People's Republic of China*, Article 1 (adopted by NPC on December 29, 1993, amended December 25, 1999, further amended August 28, 2004 and October 27, 2005 and December 28, 2013)) (Exhibit USA-2).

<sup>55</sup> See *DOC NME Report*, p. 54 (referencing *Law of the People's Republic of China on the State-Owned Assets of Enterprises* (adopted by NPC on October 28, 2008, Order No. 5, effective May 1, 2009)) (Exhibit USA-2).

<sup>56</sup> The term “state-invested enterprise” or “SIE” refers to an enterprise in which the Government of China has any ownership stake. Though the term generally has the same meaning as “state-owned enterprise” or “SOE,” the definition of “SOE” sometimes varies depending on the context in which it is used.

<sup>57</sup> *DOC NME Report*, p. 55 (Exhibit USA-2).

**b. State invested entities to control core strategic economic sectors**

32. The political and legal objective to ensure a leading role for state-invested entities is clear in the actual operation of the economy. The industries that are strategic or fundamental to production in the economy are dominated by state-invested entities and subject to heavy state intervention. China’s State-owned Assets Supervision and Administration Commission (SASAC) in accordance with guidance from China’s State Council, has conceived of economic sectors in three categories and related sub-categories, according to the perceived necessity for government control, namely: (1) strategic industries, which “affect national security and the lifeblood of the economy[’], in which the state must ‘maintain absolute controlling power’”;<sup>58</sup> (2) “basic and pillar industries’ in which the state must ‘maintain relatively strong controlling power’”;<sup>59</sup> or (3) “other industries in which the state must ‘maintain influence.’”<sup>60</sup> SASAC and local government SASACs play an active role in the management of SIEs, including investment decisions, personnel appointments, and share transactions.

33. The WTO Secretariat observed in its Report for China’s 2016 Trade Policy Review that “China continues to maintain a basic economic system in which public ownership is kept as the mainstay of the economy while allowing diverse forms of ownership to develop side by side,” and “[a]s a result, the private sector is dominant in industries such as clothing, food, and assembly for export, while sectors of strategic importance (*e.g.* energy; utilities; and transport,

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<sup>58</sup> *DOC NME Report*, p. 57 (referencing *Xinhua News Agency*, “SASAC: State-owned Economy Should Maintain Absolute Controlling Power over Seven Industries,” December 18, 2006) (Exhibit USA-2). This category comprises seven industries, namely: (i) defense, (ii) electricity grid and electricity production, (iii) petroleum and, (iv) telecommunications, (v) coal, (vi) civil aviation, and (vii) shipping. See *DOC NME Report*, p. 57 (Exhibit USA-2). The *SASAC Document* states that these seven industries (as of 2006), comprising 40 SIEs under central SASAC control (“central SIEs”), accounted for 75 percent of the total value of central SIE assets, 82 percent of state-owned assets, and 79 percent of total central SIE profits. See *DOC NME Report*, p. 57 (Exhibit USA-2). For central SIEs in these industries, the state “should ‘increase the total amount of state-owned capital and optimize structures.’” *DOC NME Report*, p. 57 (Exhibit USA-2).

<sup>59</sup> *DOC NME Report*, p. 57 (Exhibit USA-2). This category comprises nine industries: (i) machinery equipment, (ii) automotive, (iii) information technology, (iv) construction, (v) steel, (vi) nonferrous metals, (vii) chemicals, (viii) mineral surveying design, and (ix) science and technology. See *DOC NME Report*, p. 57 n.264 (Exhibit USA-2). The *SASAC Document* states that these nine industries (as of 2006) comprised 70 central SIEs, accounted for 17 percent of the total value of central SIE assets, 17 percent of state-owned assets, and 15 percent of total central SIE profits. *Ibid.*

<sup>60</sup> *DOC NME Report*, p. 57 (Exhibit USA-2). This category comprises, *inter alia*, (i) commercial logistics, (ii) investment, (iii) pharmaceuticals, (iv) construction materials, (v) agriculture, and (vi) geological surveying. See *DOC NME Report*, p. 58 (Exhibit USA-2). The *SASAC Document* states that these industries (as of 2006), comprising over 50 central SIEs, and accounted for 8 percent of the total value of central SIE assets, 6 percent of state-owned assets, and 6 percent of total central SIE profits. *Ibid.*

financial, telecom, education, and health care services) remain only partially open to private investment. These sectors are often dominated by large SOEs.”<sup>61</sup>

34. This guiding principle and policy objective of the Chinese government has a systemic impact on private firms in China’s economy. The World Bank found that “[a]lthough formal barriers to entry may be low in these industries, informal entry barriers convey the clear policy message—competition from private firms is not welcome.”<sup>62</sup> The report also argues that many government departments favor SIE investments “instead of achieving the same ends through incentives, market forces, and private sector initiatives.”<sup>63</sup>

35. The vast majority of the 115 Chinese companies on the Global Fortune 500 are state-owned,<sup>64</sup> and of these 115, 48 are controlled by central SASAC.<sup>65</sup> The ten largest SIEs in 2015 reported revenues that were nearly four times as large as the revenue reported by the ten largest private companies in China.<sup>66</sup> Also according to *Fortune China*, in 2015, 19 out of China’s 20 largest listed companies by revenue were SIEs.<sup>67</sup>

### c. State-invested entities are shielded from full market forces

36. SIEs are central to carrying out industrial policy objectives as well as the government’s macro-stabilization policies, by driving investment and maintaining economic growth.<sup>68</sup> This macro-stabilization role has required substantial low-return investments that have increased the debt burden and financial strain on SIEs. The “leading role” for the SIE sector in China is reflected in the disproportionate allocation of resources that SIEs receive relative to other types of enterprises. Many sources, including the IMF and the OECD, have concluded that China’s SIEs receive preferential access to financing from state-owned commercial banks.<sup>69</sup> SIEs also

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<sup>61</sup> See *DOC NME Report*, pp. 58-59 (quoting WTO, *Trade Policy Review – Report by the Secretariat – China*, WT/TPR/S/342 (June 15, 2016), at 95)) (Exhibit USA-2).

<sup>62</sup> See *DOC NME Report*, p. 59 (quoting World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 96299 (March 2013), 26-28, 106, 111) (Exhibit USA-2).

<sup>63</sup> See *DOC NME Report*, p. 59 (Exhibit USA-2).

<sup>64</sup> See *DOC NME Report*, p. 60 (referring to Celine Ge, “Alibaba, Tencent included in Fortune Global 500 for the First Time,” *South China Morning Post*, July 21, 2017) (Exhibit USA-2).

<sup>65</sup> See *DOC NME Report*, p. 60 (Exhibit USA-2).

<sup>66</sup> See *DOC NME Report*, pp. 60-61 (Exhibit USA-2).

<sup>67</sup> See *DOC NME Report*, p. 60 (Exhibit USA-2).

<sup>68</sup> See *DOC NME Report*, pp. 88-89 (referencing Batson, Andrew, “Villains or Victims? The Role of SOEs in China’s Economy,” *China Economic Quarterly*, June 2016, 7) (Exhibit USA-2).

<sup>69</sup> See *DOC NME Report*, pp. 88-89 (referencing IMF, *People’s Republic of China Sustainability Report 2011* (November 23, 2011)) (Exhibit USA-2).

receive preferential access to important inputs (*e.g.*, land and raw materials) and enjoy other competitive advantages unavailable to private firms.<sup>70</sup>

37. SIEs also enjoy indirect preferences by constraining private and foreign enterprises that might otherwise present significant competition to SIEs in state-favored industry sectors. A World Bank report confirms that China’s economic policies discriminate in favor of larger, state-owned firms, “resulting in ‘over abundant resource flows to (often less efficient SOEs)’ and encouraging ‘Chinese firms to expand simply as a means of gaining policy support.’”<sup>71</sup> Indeed, China issues official lists which grant SIEs an exclusive or privileged role in certain sectors.<sup>71</sup> This effectively reduces competition and holds back small- and medium-sized enterprises from developing.<sup>72</sup>

38. SIEs are largely shielded from failure. Chinese government authorities, particularly at the local level, often act on imminent concerns relating to financial stability and unemployment.<sup>73</sup> A survey of four high-profile cases of SIE restructuring between 2014 and 2015 illustrates that indebted SIEs in heavy industries such as steel, shipbuilding, and coal frequently resort to worker layoffs and other restructuring measures, but rarely file for bankruptcy.<sup>74</sup> China’s State Council has acknowledged the serious problem of economically unviable “zombie” enterprises.<sup>75</sup> International institutions have also taken note of this issue in assessments of China’s economy.<sup>76</sup> According to one study, the existence of “zombie” enterprises in a province is correlated with the extent of state-owned commercial bank operations in that province, one of several indications that banks under government influence act to support “zombie” enterprises.<sup>77</sup>

39. Implicit guarantees provided to SIEs result in borrowing costs that are not commensurate with risks and returns, distorting the allocation of resources and promoting inefficiency in the

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<sup>70</sup> See *DOC NME Report*, pp. 89-90 (referencing World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 96299 (March 2013), 25) (Exhibit USA-2).

<sup>71</sup> See *DOC NME Report*, p. 90 (referencing World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 96299 (March 2013), 105) (Exhibit USA-2).

<sup>72</sup> See *DOC NME Report* at 90 (Exhibit USA-2).

<sup>73</sup> *DOC NME Report*, p. 72 (referencing Jianguang Shen, “Dealing with Zombie Companies and Overcapacity in China,” *Economics Weekly* (47) (Mizuho Securities Asia Ltd. Economics Research, November 20, 2015), 3) (Exhibit USA-2).

<sup>74</sup> *DOC NME Report*, p. 72 (Exhibit USA-2).

<sup>75</sup> *DOC NME Report*, p. 71 (referencing IMF, *The People’s Republic of China: Selected Issues*, IMF Country Report No. 16/271 (July 2016), 39) (Exhibit USA-2).

<sup>76</sup> *DOC NME Report*, p. 71 (referencing IMF, *2015 Article IV Consultation – Press Release: Staff Report; and Statement by the Executive Director for the People’s Republic of China*, IMF Country Report No. 15/234 (IMF, August 2015), 17; OECD, *OECD Economic Surveys: China*, (Paris: OECD Publishing, 2017), 41) (Exhibit USA-2).

<sup>77</sup> *DOC NME Report*, p. 71 (referencing Yuyan Tan, Yiping Huang, Wing Thye Woo, “Zombie Firms and the Crowding-Out of Private Investment in China,” *Asian Economic Papers* 15(3) (2016): 32-55) (Exhibit USA-2).

SIE sector and the economy as a whole.<sup>78</sup> Both the IMF and the World Bank have found implicit government guarantees to be a significant impediment to efficient business exit in China’s economy.<sup>79</sup>

40. The IMF recommended that mechanisms for enterprise restructuring in China “be ‘market-based, rather than relying on *forced mergers* between weak and strong firms’ (emphasis added).”<sup>80</sup> Scholars have similarly suggested that the government at times pressures enterprises to participate in M&A transactions.<sup>81</sup> A 2013 legal study notes an “evolving dynamic” by which national, state-owned business groups purchase smaller SIEs at the province- and sub-province-level, subject to pressures exerted by the Chinese government.<sup>82</sup>

41. During the 18th Party Congress (2012-2017), the Chinese Communist Party issued policies with the aim of modifying various aspects of government ownership in the economy. One stated goal was for China “to ‘[v]igorously develop... a mixed economy,’ through, among other means, ‘allow[ing] more state-owned enterprises (SOEs) and enterprises of other types of ownership to develop into mixed enterprises.’”<sup>83</sup> Analysts have pointed out that mixed-ownership reform is not likely to lead to fundamental changes in the operations or role of SIEs in China’s economy unless the CCP is willing to cede control.<sup>84</sup> Mixed ownership may allow for the transfer of productive capital to state-owned firms, but it has not introduced market mechanisms into firms still controlled by the government.<sup>85</sup> State Council guidelines issued in

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<sup>78</sup> *DOC NME Report*, p. 72 (referencing IMF, *The People’s Republic of China: Selected Issues*, IMF Country Report No. 16/271 (July 2016), 33, 34, and 40) (Exhibit USA-2).

<sup>79</sup> *DOC NME Report*, p. 73 (referencing IMF, *2015 Article IV Consultation – Press Release: Staff Report; and Statement by the Executive Director for the People’s Republic of China*, IMF Country Report No. 15/234 (August 2015), 16 and World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 96299 (March 2013), 401) (Exhibit USA-2).

<sup>80</sup> *DOC NME Report*, p. 79 (referencing IMF, *2016 Article IV Consultation – Press Release: Staff Report; and Statement by the Executive Director for the People’s Republic of China*, IMF Country Report No. 16/270 (August 2016), 20) (Exhibit USA-2).

<sup>81</sup> *DOC NME Report*, p. 78 (Exhibit USA-2).

<sup>82</sup> *DOC NME Report*, p. 79 (referencing Liwen Lin and Curtis Milhaupt, “We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China,” *Stanford Law Review* 65(4) (May 2013): 725-726) (Exhibit USA-2).

<sup>83</sup> *DOC NME Report*, pp. 90-91 (referencing *Third Plenum Decision*, Article 6. Pursuant to the *Third Plenum Decision*, the CCP Central Committee and State Council in 2015 jointly issued the *Guiding Opinion on Deepening Reform of State-owned Enterprises* (“*SOE Reform Opinion*”); *Guiding Opinion on Deepening Reform of State-owned Enterprises*, Articles 7, 17, and 19 (CCP Central Committee and State Council, Guo Fa [2015] No. 22, issued August 24, 2015) (Exhibit USA-2).

<sup>84</sup> *DOC NME Report*, p. 92 (referencing Curtis J. Milhaupt and Wentong Zheng, *Why Mixed-Ownership Reforms Cannot Fix China’s State Sector*, Paulson Policy Memorandum (January 2016), 19-20) (Exhibit USA-2).

<sup>85</sup> *DOC NME Report*, p. 92 (referencing Marshall W. Meyer and Changqi Wu, *Making Ownership Matter: Prospects for China’s Mixed Ownership Economy*, Paulson Policy Brief (September 2014), 2) (Exhibit USA-2).

2015 to promote mixed ownership reaffirm that state capital should have “the absolute controlling position.”<sup>86</sup>

**d. Exercise of control through the Communist Party in State and private enterprises**

42. The Chinese Communist Party is the constitutional, legal and *de facto* source of authority for governance in China.<sup>87</sup> China’s *Constitution* formally entrenches the CCP at the apex of China’s legal hierarchy, where it occupies a position “above the law.”<sup>88</sup> It repeatedly emphasizes the “leadership” role of the CCP and does not limit the CCP’s exercise of power.<sup>89</sup> China’s *Constitution* supports the CCP’s instrumental use of law to achieve its political and economic objectives.<sup>90</sup> The CCP’s primacy over the law is reflected in its control over China’s legal and lawmaking institutions, including the People’s Congresses at the central and local levels of government, and the People’s Courts.<sup>91</sup>

43. In this context, the Chinese Communist Party exercises significant influence over the SIE sector through personnel appointments and the operation of party committees. The Organization Department under the CCP Secretariat appoints individuals to leading positions in the CCP, the government, and the military, as well as in SIEs and other institutions.<sup>92</sup> Under this system, which originated in the Soviet Union, the CCP maintains a list of individuals whom it may appoint, dismiss, or hold in reserve for important leadership positions, in accordance with an

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<sup>86</sup> *DOC NME Report*, p. 92 (referencing *Xinhua News Agency*, “China Urges SOE Modernization Through Mixed Ownership Reform,” September 24, 2015) (Exhibit USA-2).

<sup>87</sup> *DOC NME Report*, p. 82 (referencing Shauna Biby, Christopher Cassel, and Timothy Hruby, *The relevance of the Chinese Communist Party for the limited purpose of determining whether particular enterprises should be considered to be “public bodies” within the context of a countervailing duty investigation*, Memorandum of Proceedings (U.S. Department of Commerce, 2012), 3) (Exhibit USA-2).

<sup>88</sup> *DOC NME Report*, pp. 181-186 discussing China’s legal system and relationship to CCP, (referencing Donald Clarke, *China’s Legal System and the Fourth Plenum*, Public Law Research Paper No. 2015-27 (George Washington University Law School, 2015), 1-2 (noting recently announced legal reforms, “the party will remain above the law” and that “the system in which powerful interests can override the law if they wish remains comfortably in place.”)) (Exhibit USA-2).

<sup>89</sup> *DOC NME Report*, pp. 181-186 (Exhibit USA-2).

<sup>90</sup> *DOC NME Report*, p. 182 (referencing Rogier Creemers, “China’s Constitutionalism Debate: Content, Context And Implications,” *The China Journal* 74 (2015), 108 (the “[l]aw is considered as one among many political instruments that can be used to achieve [the CCP’s] desired outcomes and coordinate actors’ activities.”); Jacques de Lisle, “Law in the China Model 2.0: Legality, Developmentalism and Leninism under Xi Jinpi” *Journal of Contemporary China* 26 (2017): 83 (“[The Xi regime’s] narrowly instrumentalist conception of law (which implies that perceived conflicts between law reform and the goals of economic development and political stability will not be resolved in law’s favor.”)) (Exhibit USA-2).

<sup>91</sup> *DOC NME Report*, p. 182 (Exhibit USA-2).

<sup>92</sup> *DOC NME Report*, p. 82 (referencing Richard McGregor, *The Party: The Secret World of China’s Communist Rulers* (New York: HarperCollins, 2010), 49-50 (stating that “the CCP has remained unyielding on a number of fronts. Its control over personnel appointments has been inviolate.”)) (Exhibit USA-2).

intricate ranking system.<sup>93</sup> The CCP Organization Department can function to discipline and control leaders in both government and business.<sup>94</sup> In so doing, it can blur the line between the state and the private sector, and influence executives in SIEs.<sup>95</sup>

44. The CCP can direct SIE management to cycle between SIEs and government bodies.<sup>96</sup> The OECD noted in 2017 that “[a] major link between business and politics is the appointment system and the intertwined career paths in the public administration and the SOE system, where progress has so far been modest . . . . Sometimes SOE managers appear to fare worse than their private peers in profit maximisation or raising the market value of the firm but those may not be their primary goals, which include public policy objectives.”<sup>97</sup> As one scholar describes: “[M]ore disorienting is the frequent interchange of senior figures in the *nomenklatura* between even competing firms in the same industry, a kind of musical chairs played not just at the very highest level, but at the operational level as well.”<sup>98</sup> The CCP’s appointment power appears to influence SIE operations. As one source explains, “[T]he CCP ‘can intervene for any reason, changing CEOs, investing in new projects or ordering mergers,’ regardless of the laws that are in place.”<sup>99</sup>

45. Party influence is reinforced by the existence of Party Committees that can exercise influence over enterprise decisions. According to the *Company Law*, an organization of the CCP may be set up in all enterprises, regardless of whether it is a state, private, domestic or foreign-

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<sup>93</sup> *DOC NME Report*, p. 82 (referencing Zheng Yongnian, *The Chinese Communist Party as Organizational Emperor: Culture, Reproduction, and Transformation* (London: Routledge, 2010), 103-104 (“The CCP’s most powerful instrument in structuring its domination over the state is a system called the ‘Party management of cadres’ (*dangguan ganbu*), or more commonly known in the West as the *nomenklatura* system. The *nomenklatura* system ‘consists of lists of leading positions, over which Party units exercise the power to make appointments and dismissals; lists of reserves or candidates for these positions; and institutions and processes for making the appropriate personnel changes.’”)) (Exhibit USA-2).

<sup>94</sup> *DOC NME Report*, p. 83 (referencing Tony Saich, *Governance and Politics of China* (New York: Palgrave MacMillan, 2011), 123) (Exhibit USA-2).

<sup>95</sup> *DOC NME Report*, p. 83 (referencing Carl Walter and Fraser J.T. Howie, *Red Capitalism: The Fragile Financial Foundation of China’s Extraordinary Rise* (Singapore: John Wiley & Sons (Asia) Pte. Ltd., 2011), 24 and Richard McGregor, *The Party: The Secret World of China’s Communist Rulers* (New York: Harper, 2010, 68) (Exhibit USA-2).

<sup>96</sup> *DOC NME Report*, p. 82-88 (discussing CCP mechanisms of control in companies and listing examples of CCP direction to shuffle SIE executives between government and industry) (Exhibit USA-2).

<sup>97</sup> *DOC NME Report*, p. 86 (referencing OECD, *OECD Economic Surveys: China*, (Paris: OECD Publishing, 2017), 44) (Exhibit USA-2).

<sup>98</sup> *DOC NME Report*, p. 85 (referencing Nicholas Calcina Howson, “China’s Restructured Commercial Banks: Nomenklatura Accountability Serving Corporate Governance Reform?” in *China’s Emerging Financial Markets Challenges and Global Impact*, eds. Min Zhu, Jinqing Cai, and Martha Avery (Singapore: John Wiley & Sons (Asia) Pte. Ltd., 2009), 144) (Exhibit USA-2).

<sup>99</sup> *DOC NME Report*, p. 86 (referencing Carl Walter and Fraser J.T. Howie, *Red Capitalism: The Fragile Financial Foundation of China’s Extraordinary Rise* (Singapore: John Wiley & Sons (Asia) Pte. Ltd., 2011), 24) (Exhibit USA-2).

invested enterprise, to carry out activities of the Chinese Communist Party.<sup>100</sup> Party committees in SIEs, are subsequently subject to party discipline and control.<sup>101</sup> The *CCP Constitution* states that in SIEs, the CCP ““primary party organization”” is to ““participate[] in making final decisions on major questions in the enterprise.””<sup>102</sup> While a lack of transparency exists regarding the precise role party committees play in enterprise decision-making, studies have found their influence to be substantial, particularly in SIEs. A 2010 OECD report notes that Party committees in SIEs ““often play an active role in human resources and the strategic decision making of the enterprise.””<sup>103</sup> Other survey evidence confirms the active role of party committees in many SIEs.<sup>104</sup>

46. The formal parallel structure within SIEs, wherein corporate and CCP leaders operate side-by-side influences the independence of corporate board decisions. As one recent examination states:

In particular, the widespread joint appointment of board chairman and party secretary undermines outside investors’ confidence in boards of directors. Specifically, it implies that the board’s independent decision-making authority may be subject to influence by the CCP committee, suggests the possibility of political priorities trumping profit maximization, and underscores the state’s predominant authority to shareholders already wary about protection of their interests.<sup>105</sup>

47. The role of Party Committees also extends to private enterprises. It has been noted that the linkages between the private sector and the CCP became tighter as there has been an official acceptance of private entrepreneurs along with active efforts to recruit them into the CCP.<sup>106</sup> According to China’s official Xinhua News Agency, 51.8 percent of all non-state firms had in-house CCP cells in 2015 and that percentage increased to 67.9 percent in 2016.<sup>107</sup> The presence

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<sup>100</sup> *DOC NME Report*, p. 86 (Exhibit USA-2).

<sup>101</sup> *DOC NME Report*, p. 86 (Exhibit USA-2).

<sup>102</sup> *DOC NME Report*, p. 86 (Exhibit USA-2).

<sup>103</sup> *DOC NME Report*, pp. 86-87 (referencing OECD, *OECD Economic Surveys: China 2010* (Paris: OECD Publishing, 2010), 116) (Exhibit USA-2).

<sup>104</sup> *DOC NME Report*, p. 86 (Exhibit USA-2).

<sup>105</sup> See *DOC NME Report*, p. 87 (referencing Wendy Leutert, “Challenges Ahead in China’s Reform of State-Owned Enterprises,” *Asia Policy* 21 (January 2016), 95) (Exhibit USA-2).

<sup>106</sup> *DOC NME Report*, p. 87 (referencing Cheng Li, “China’s Communist Party State: The Structure and Dynamics of Power,” in *Politics in China: An Introduction*, ed. William A. Joseph (Oxford: Oxford University Press, 2010), 205) (Exhibit USA-2).

<sup>107</sup> *DOC NME Report*, p. 87 (referencing *Xinhua News Agency*, “Authorized Announcement: 2015 Annual Chinese Communist Party Statistics Report,” June 30, 2016) (Exhibit USA-2). The 2016 report is available at [http://news.xinhuanet.com/politics/2017-06/30/c\\_1121242478.htm](http://news.xinhuanet.com/politics/2017-06/30/c_1121242478.htm).



of Party Committees can constrain overall decision-making of private firms.<sup>108</sup> According to one study, “membership in the CCP is often regarded as a minimum requirement for a career as professional managers – particularly in SOEs, and *in private firms that exceed a certain size and influence.*”<sup>109</sup>

48. Recent reports note that the CCP is also explicitly writing itself into the articles of association of large enterprises such as the bank ICBC and Sinopec.<sup>110</sup>

49. In addition, the CCP plays a leading role in implementing industrial policies. The CCP Central Committee has formal power to approve each Five-Year Plan (“FYP”), in conjunction with the State Council. Importantly, the *13th Five-Year Plan for Economic and Social Development (2016-2020)* (“13<sup>th</sup> FYP”) also appears to contain more forceful language than previous FYPs regarding the CCP’s role in overseeing implementation of the FYP.<sup>111</sup> This modification in the FYP has coincided with reports of increased CCP control over administrative and economic activity in China. CCP members at all levels are now subject to multiple new and wide-ranging disciplinary measures, which seek in part to ensure implementation of central government and CCP policies.<sup>112</sup>

50. The CCP’s leading role in industrial policymaking is also evident in its institutional makeup.<sup>113</sup> At the central government level, the CCP Central Committee comprises Departments, Commissions, and Central Leading Small Groups, several of which participate in industrial policymaking. For example, at the policy formulation stage, the Central Finance and

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<sup>108</sup> *DOC NME Report*, p. 88 (referencing Regina M. Abrami, William C. Kirby, and F. Warren McFarlan, “Why China Can’t Innovate,” *Harvard Business Review* (March 2014)) (Exhibit USA-2).

<sup>109</sup> *DOC NME Report*, p. 88 (referencing Victor Nee and Sonja Opper, “On Politicized Capitalism,” in *On Capitalism*, eds. Victor Nee and Richard Swedberg (Stanford: Stanford University Press, 2007), 109) (emphasis added) (Exhibit USA-2).

<sup>110</sup> *DOC NME Report*, p. 88 (referencing Jennifer Hughes, “China’s Communist Party Writes Itself into Company Law,” *Financial Times*, August 15, 2017) (Exhibit USA-2). Article 8 of the Articles of Association for the China Pacific Insurance Group states that, “In making decision for material issues of the Company, the Board of Directors shall first seek for the opinion of the Leading Party Group of the Company. For significant issues regarding operation and management, such as national macro-control, national development strategies and national security, the Board of Directors shall make decisions by making reference to the conclusion of the study and discussion of the Leading Party Group, which is considered to be important evidence for decision-making.” Exhibit USA-4. Article 105 of PetroChina’s Articles of Association states, “The board of directors shall take the Party organization’s advices before it determines the material matters, such as the orientations of the Company’s reform and development, key objectives/tasks and major work arrangements. When the board of directors intends to appoint the management personnel, the Party organizations shall consider and put forward their advices on the candidates nominated by the board of directors or the president, or nominate candidates to the board of directors and the president.” Exhibit USA-4.

<sup>111</sup> *DOC NME Report*, p. 125 (referencing Chapter XX of the 13<sup>th</sup> FYP) (Exhibit USA-2).

<sup>112</sup> *DOC NME Report*, p. 126 (referencing Jude Blanchette, *Back to Basics: The CCP at 95*, (The Conference Board, September 2016), 1-4) (Exhibit USA-2).

<sup>113</sup> *DOC NME Report*, p. 126 (Exhibit USA-2).

Economy Leading Small Group coordinates closely with NDRC.<sup>114</sup> The newly established Central Leading Small Group for Comprehensively Deepening Reforms, established at the Third Plenary Session of the 18th National Congress of the CCP and expected to run through the year 2020, also influences the current planning work of NDRC and other government departments.<sup>115</sup>

## **2. Distortion in the allocation of economic resources as a result of State control**

51. China's existing legal and political framework does not aim to establish a market economy; rather the objective is the development of an economy in which state control and direction is predominant. The following discussion illustrates how China's government and the Chinese Communist Party employ key instruments, such as formal industrial policy and control over financial institutions, to achieve non-market outcomes.

### **a. Industrial policy distortions**

52. While many countries may have some form of industrial policy, the Chinese government's system and implementation is distinctive in terms of its complexity and pervasiveness, as well as its reliance on direct interventions to allocate resources to sectors of China's economy. The objective of the Chinese government and the Chinese Communist Party is to maintain an economy in which the Party-state directs and channels economic actors to meet the goals of state planning, not for economic outcomes that reflect predominantly market forces acting independent of the Party-state. In this context, industrial policies convey instructions regarding sector-specific economic objectives, particularly for those sectors deemed strategic and fundamental.

#### **i. China's industrial policy pervades every aspect of its economy**

53. Industrial policies in China today are extensive. A core organizing principle of these policies remains the five-year planning period, first instituted in 1953-1957 based on the practice of the Soviet Union.<sup>116</sup> The *13th FYP*, issued in March 2016, is divided into twenty chapters, which unify plans for the national development of agriculture, industry, infrastructure and communications, regional economic zones, and foreign trade and investment; health, education, and welfare; the CCP-led political system; and national defense.<sup>117</sup> Each sub-national

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<sup>114</sup> *DOC NME Report*, p. 126 (referencing Sebastian Heilmann and Leah Shih, "The Chinese Communist Party," in *China's Political System*, ed. Sebastian Heilmann (New York: Rowman & Littlefield, 2017), 77-78) (Exhibit USA-2).

<sup>115</sup> *DOC NME Report*, p. 126 (Exhibit USA-2).

<sup>116</sup> See *DOC NME Report*, pp. 118-120 for historical and current context (Exhibit USA-2).

<sup>117</sup> *DOC NME Report*, p. 118 (Exhibit USA-2).

government authority issues its own *FYP*, pursuant to the central government document as do SIEs.<sup>118</sup>

54. China also issues specialized plans that translate industrial policy elements into sector-specific five-year plans. For the 13th five-year planning period, there are over 100 such plans, including, *inter alia*, for energy, raw material, and farm sectors; technology- and capital-intensive industries; and important facets of economic regulation, such as intellectual property and fair competition.<sup>119</sup> Plans are also issued for years that exceed five years: in the high-tech sector, for example, China has issued the *Medium- and Long-Term Plan for Science and Technology (2006-2020)* (“*S&T MLP*”)<sup>120</sup> and the *Decision on Issuing “China Manufacturing 2025”* (“*Made in China 2025 Decision*”).<sup>121</sup>

**ii. China’s industrial policies manipulate specific economic outcomes**

55. Planning documents are often highly specific with respect to sub-sectors, products, materials, processes, and technologies for further development. For example, the *12th Five-Year Development Plan for New Materials* pinpoints specific industrial materials that China should prioritize for the development of a wide range of high-technology applications.<sup>122</sup>

56. Another example is the *Made in China 2025 Decision*,<sup>123</sup> which outlines a new medium- and long-term strategy for technology development. One goal under the *Made in China 2025* (“*MiC2025*”) is production self-sufficiency. Specifically, the government’s specific self-sufficiency (localization) target for domestically sourced essential parts and key materials under *MiC2025* is a 40 percent share of the market by 2020, and a 70 percent share by 2025.<sup>124</sup> In 2017, the Chinese government continues to use an industrial policy-based approach to innovation that has the effect of selecting winners and losers by targeting specific technologies and sectors,

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<sup>118</sup> *DOC NME Report*, pp. 119 and 129-130 (Exhibit USA-2).

<sup>119</sup> *DOC NME Report*, p. 120 (noting that for the *11th FYP* period, Heilmann and Melton identify “roughly 160 national-level special plans.” Sebastian Heilmann and Oliver Melton, “The Reinvention of Development Planning in China, 1993-2012,” *Modern China* 39(6) (2013): 595) (Exhibit USA-2).

<sup>120</sup> *DOC NME Report*, p. 120 (Exhibit USA-2).

<sup>121</sup> *DOC NME Report*, p. 120 (Exhibit USA-2).

<sup>122</sup> *DOC NME Report*, p. 122 (Exhibit USA-2).

<sup>123</sup> *DOC NME Report*, p. 148 (Exhibit USA-2).

<sup>124</sup> *DOC NME Report*, p. 148 (referencing Jost Wubbeke et al., *Made in China 2025: The Making of a High-Tech Superpower and Consequences for Industrial Countries*, MERICS Papers on China No. 2 (Mercator Institute for China Studies, December 2016), 7, 11) (Exhibit USA-2).

and then encouraging their development, both directly and indirectly, through financial supports, investment, and other means.<sup>125</sup>

**iii. State intervention and implementation of industrial policy**

(a) Targets and tasking processes

57. China’s government maintains a formal system for assigning implementation tasks and reviewing their execution. Tasking documents cascade from the level of the State Council and its subordinate ministries down to the local level. For the purposes of implementing the *11th Five-Year Plan for Economic and Social Development (2006-2010)* (“*11th FYP*”), for example, the State Council issued the *Notice on Principal Objectives and the Division of Work Tasks to Fulfill the Outline of the PRC 11th Five-Year Plan for Economic and Social Development*,<sup>126</sup> and a similar document was issued for the *12th FYP*.<sup>127</sup> These documents list which government department will be responsible for, or lead, the implementation of each item of the *FYP*.

58. Planning targets are an important element of China’s industrial policy.<sup>128</sup> A subset of targets is formalized into a dual system of “binding targets” and “indicative targets.”<sup>129</sup> For example, the *12th Five-Year Plan for Economic and Social Development (2011-2015)* (“*12th FYP*”) contains a series of “binding targets” pertaining, *inter alia*, to arable land supply, energy intensity, pollution emissions, and welfare provision. It also contains a series of “indicative targets” pertaining, *inter alia*, to per capita income growth, the unemployment rate, the services sector share of GDP, the urbanization rate, grain comprehensive production capacity, R&D spending as a share of GDP, and patent ownership per 10,000 people.<sup>130</sup> Another example is the *National Mineral Resource Plan (2016-2020)*, which provides “indicative targets” for the level of production of one set of resources (including oil, gas, coal, iron ore, and various nonferrous metals) and “binding targets” for the level of production of tungsten and rare earths.<sup>131</sup> A 2017 policy document issued by the Ministry of Science and Technology, moreover, instructs officials to prescribe both “binding targets” and “indicative targets” when drafting science and technology

<sup>125</sup> *DOC NME Report*, p. 148 (referencing European Union Chamber of Commerce in China, *China Manufacturing 2025: Putting Industrial Policy Ahead of Market Forces* (2017), 1) (Exhibit USA-2).

<sup>126</sup> *DOC NME Report*, pp. 122-123 (Exhibit USA-2).

<sup>127</sup> *DOC NME Report*, pp. 122-123 (Exhibit USA-2).

<sup>128</sup> *DOC NME Report*, p. 121 (Exhibit USA-2).

<sup>129</sup> *DOC NME Report*, p. 121 (referencing Sebastian Heilmann and Oliver Melton, “The Reinvention of Development Planning in China, 1993-2012,” *Modern China* 39(6) (2013): 609-611; Sebastian Heilmann, “Economic Governance: Authoritarian Upgrading and Innovative Potential,” in *China Today, China Tomorrow: Domestic Politics, Economy, and Society*, ed. Joseph Fewsmith (Lanham: Rowman & Littlefield, 2010), 116-118) (Exhibit USA-2).

<sup>130</sup> *DOC NME Report*, p. 121 (Exhibit USA-2).

<sup>131</sup> *DOC NME Report*, p. 121 (Exhibit USA-2).

development plans for the “2030 Sustainable Development Initiative Innovation Demonstration Zones.”<sup>132</sup> Fulfillment of “binding targets,” in particular, is a formal component of evaluating the performance of government officials,<sup>133</sup> and also entails direct allocation of funding and stringent administrative oversight.<sup>134</sup> To fulfill “indicative targets,” the government uses methods such as policy signaling (*e.g.*, announcements about changes to fiscal policy) and indirect incentives (*e.g.*, improved access to bank loans) to inform the behavior of government officials and economic actors.<sup>135</sup>

59. China’s government scores and evaluates progress towards plan goals. For example, in its *Notice on Launching the Mid-Term Evaluation of “12th Five-Year Plan” Outline*,<sup>136</sup> the key ministry involved in planning, the National Development and Reform Commission, sets forth an intricate point-tallying system to evaluate implementation of each aspect of the *12th FYP*. An annual review of the previous year’s performance and the setting of targets for the coming year is presented by NDRC each March.<sup>137</sup>

(b) Investment restrictions and approval processes

60. The Chinese government’s framework for granting or denying access for a market entry of an entity, product, or activity serves important industrial policy objectives. In many cases, the Chinese investment regime reserves the right for the government to review and approve domestic and foreign investments.

61. To achieve its industrial policy objectives, the government regulates investment flows from both foreign and domestic sources, to favored and disfavored firms, products, technologies, and industries. Various industrial policy measures, including the *State Council Decision on Implementing the Interim Provisions on Promoting the Structural Adjustment of Industry* provide that an FDI catalogue and related measures should be formulated in accordance with these industrial policies.<sup>138</sup>

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<sup>132</sup> *DOC NME Report*, p. 121 (Exhibit USA-2).

<sup>133</sup> *DOC NME Report*, p. 121 (referencing Sebastian Heilmann and Oliver Melton, “The Reinvention of Development Planning in China, 1993-2012,” *Modern China* 39(6) (2013): 609. (“In China, the linkage between plan targets and cadre assessments was loose and unsystematic until the early 1990s. From the early 1990s on, as a result of a thorough overhaul of the party’s personnel system, cadre evaluations became more systematic and started to include more economic and social indicators than just GDP growth or unemployment in each leading cadre’s jurisdiction.”)) (Exhibit USA-2).

<sup>134</sup> *DOC NME Report*, p. 122 (Exhibit USA-2).

<sup>135</sup> *DOC NME Report*, p. 122 (Exhibit USA-2).

<sup>136</sup> *DOC NME Report*, p. 122 (Exhibit USA-2).

<sup>137</sup> *DOC NME Report*, p. 122 (Exhibit USA-2).

<sup>138</sup> *See DOC NME Report*, pp. 132, 141-145 (Exhibit USA-2).

62. China’s government uses its foreign investment regime to serve its industrial policy objectives.<sup>139</sup> The Chinese government’s restrictions on foreign investment are often highly targeted and detail specific sub-sectors that are consistent with its industrial policies, such as encouraging foreign investment in key components, equipment and technologies that the government deems to be critical to the development of China’s domestic industry and its industrial capabilities. For example, China’s foreign investment regime encourages foreign investment in civil aircraft and aircraft components, but restricts foreign investment in the manufacture of commercial aircraft to joint ventures in which the Chinese party holds a controlling interest. These foreign investment policies serve to further the Chinese government’s industrial policy objective of developing a “national champion” to produce commercial aircraft with the assistance of foreign technology and expertise.<sup>140</sup>

63. The effects of these policies are reflected in China’s ranking on the OECD’s Foreign Direct Investment (FDI) Regulatory Restrictiveness Index, which has found the Chinese government’s foreign investment regime as one of the most restrictive in the world. In 2016, the OECD FDI Regulatory Restrictiveness Index ranked China 59<sup>th</sup> out of 62 countries in 2016, just after Myanmar and five times as restrictive as the country average.<sup>141</sup>

(c) Guidance catalogues

64. China issues different catalogues that provide guidance on the implementation of its industrial policies that set forth, *inter alia*, sectors entitled to preferential treatment; sectors in which investment is “encouraged,” “permitted,” or “prohibited”; and products that are subject to licenses or export taxes.<sup>142</sup> As the WTO found in its *Trade Policy Review* of China, five-year plans will often provide the overarching industrial policy objective, while a detailed and often extensive guidance catalogue will provide the implementation details.<sup>143</sup>

65. Various government authorities also issue catalogues in accordance with a national program. For example, to implement the *12th FYP* goals for “strategic and emerging industry” (SEI) development, various central and sub-central government authorities have issued catalogues concerning SEIs, which provide details regarding the sub-sectors and specific products that qualify as SEIs. Sectors and products covered by these catalogues may be entitled

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<sup>139</sup> The discussion below draws from the *DOC NME Report*, pp. 32-51 (Exhibit USA-2).

<sup>140</sup> *DOC NME Report*, p. 41 (referencing Keith Crane *et al.*, *The Effectiveness of China’s Industrial Policies in Commercial Aviation Manufacturing* (Rand Corporation, 2014)) (Exhibit USA-2).

<sup>141</sup> *DOC NME Report*, pp. 38-39 (referencing OECD, *FDI Regulatory Restrictiveness Index – Rankings* (December 2016), available at <http://www.oecd.org/investment/fdiindex.htm>, accessed September 17, 2017) (Exhibit USA-2).

<sup>142</sup> *DOC NME Report*, p. 134, (referencing WTO, *Trade Policy Review, The People’s Republic of China*, WT/TPR/S/342 (June 15, 2016), 35) (Exhibit USA-2).

<sup>143</sup> *DOC NME Report*, p. 134 (Exhibit USA-2).

to various forms of financial support, including preferred access to credit, grants, tax incentives, investments, and other preferential treatment.<sup>144</sup>

(d) Access conditions

66. “Access conditions” are administrative tools used by the Chinese government to achieve multiple objectives, including, *inter alia*, encouraging the adoption of new technologies, restricting market access, and shedding capacity in heavy industry sectors. Enterprises that meet industry access conditions may be entitled to certain benefits while enterprises that fail to meet the conditions may face closure or restrictions on expansion. Industry access conditions are used in a wide variety of industries. For example, with respect to new energy vehicles, the Chinese government issued market access rules for manufacturers, such that conformity with the rules serves as a precondition for receiving government subsidies.<sup>145</sup>

67. In the steel industry, the *Iron and Steel Industry Standard Conditions* were issued in 2010, 2012, and 2015.<sup>146</sup> According to its terms, the standards serve as the fundamental condition for the production and operation of the steelmaking industry.<sup>147</sup> In addition to setting environmental and safety standards, the standard conditions cover a wide range of topics that relate to basic operational and business decisions, including product quality, production method and equipment, and energy consumption and resource usage, and include detailed specifications for each. For example, according to the 2015 standard conditions, under the production method and equipment category, for existing steelmaking enterprises, blast furnaces must have a capacity of at least 400 cubic meters and electric furnaces must have a capacity of at least 30 metric tons.<sup>148</sup> Highly targeted government intervention such as this can distort market outcomes.

68. These industry conditions offer incentives for compliance and disincentives for non-compliance. Enterprises that do not meet the standards may be forced to restructure, and local governments are directed to adopt legal, economic, and market measures to restructure these enterprises and phase out unqualified enterprises.<sup>149</sup>

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<sup>144</sup> *DOC NME Report*, p. 136 (referencing Markus Taube, *Analysis of Market Distortions in the Chinese Non-Ferrous Metals Industry* (Berlin: Think!Desk China Research and Consulting, April 24, 2017), 88-93 and WTO, *Trade Policy Review, The People’s Republic of China*, WT/TPR/S/342 (June 15, 2016), 80-81) (Exhibit USA-2).

<sup>145</sup> *DOC NME Report*, p. 133 (Exhibit USA-2).

<sup>146</sup> *DOC NME Report*, pp. 133-134 (Exhibit USA-2).

<sup>147</sup> *DOC NME Report*, pp. 133-134 (Exhibit USA-2).

<sup>148</sup> *DOC NME Report*, pp. 133-134 (Exhibit USA-2).

<sup>149</sup> *DOC NME Report*, p. 134 (Exhibit USA-2).

(e) Financial support

69. In its 2016 *Trade Policy Review* of China, the WTO concluded that China continues to provide various incentives to different sectors or industries, for the purpose of, *inter alia*, “upgrading production methods in industries that use obsolete technologies; promoting development in remote areas and narrowing the income gap between regions; and attracting FDI.”<sup>150</sup> A 2015 report commissioned by AEGIS Europe and the Cross-sector Alliance Representing European Manufacturing, moreover, identifies government support reported in the public filings of hundreds of listed Chinese companies, most of which are state-owned. The report finds that important objectives behind these subsidies are to promote domestic technology upgrading and high-tech sectors; promote strategic emerging industries; and fund revitalization and technological renovation in key industries.<sup>151</sup> Two in-depth studies of the steel and nonferrous metals sectors, respectively, list a broad set of financial supports offered by sub-central governments, including, *inter alia*, tax incentives, financial grants, “export subsidies,” and “energy subsidies.” In many cases, these supports are offered in a coordinated manner to support specific government initiatives. For example, “subsidies” related to technology renovation in key industries; in support of trademark and patent registration; as compensation for R&D expenses; and in direct support of enterprises classified as high and new technology enterprises.<sup>152</sup>

70. International institutions have also taken note of financial supports provided by the Chinese government. The WTO has found that the Chinese government generally provides “tax preferences, direct transfers, and access to credit.”<sup>153</sup> The OECD similarly concluded that the “widespread misallocation of resources” in China has been “exacerbated by local authorities’ growth-seeking behaviour as they competed to offer low-cost or free land, cheap credit, tax concessions and other subsidies to attract investment.”<sup>154</sup>

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<sup>150</sup> *DOC NME Report*, p. 136 (referencing WTO, *Trade Policy Review, The People’s Republic of China*, WT/TPR/S/342 (June 15, 2016), 80) (Exhibit USA-2).

<sup>151</sup> *DOC NME Report*, p. 136 (referencing Markus Taube and Christian Schmidkronz, *Assessment of the Normative and Policy Framework Governing the Chinese Economy and Its Impact on International Competition*, Final Extended Report for AEGIS Europe (Think!Desk China Research & Consulting, August 13, 2015), 72-127) (Exhibit USA-2).

<sup>152</sup> *DOC NME Report*, p. 137 (referencing Markus Taube and Peter in der Heiden, *China Steel Inc. – State-owned and State-run? An Investigation of State-Business Interaction in the World’s Largest Steel Industry*, vol. 8 of *Economic Studies on Asia* (Marburg: Metropolis, 2010), 129-145; Markus Taube, *Analysis of Market Distortions in the Chinese Non-Ferrous Metals Industry* (Berlin: Think!Desk China Research and Consulting, April 24, 2017), 53-93) (Exhibit USA-2).

<sup>153</sup> *DOC NME Report*, p. 136 (referencing WTO, *Trade Policy Review, The People’s Republic of China*, WT/TPR/S/342 (June 15, 2016), 80) (Exhibit USA-2).

<sup>154</sup> *DOC NME Report*, p. 137 (referencing OECD, *OECD Economic Surveys: China* (Paris: OECD Publishing, 2015), 31) (Exhibit USA-2).



(f) Excess capacity

71. Excess capacity has been one notable result of these policies and has been a longstanding and widespread problem in China’s economy. Its scale is indicated by low capacity utilization rates in numerous industries, including iron and steel, coal and coke, cement, flat glass, shipbuilding, semi-conductors, construction materials, chemical fertilizers, metal-cutting machine tools, micro-computer equipment, autos, consumer appliances, phone sets, cell phones, petrochemicals, aluminum, optic fiber, carbon fiber, power generation (thermal, solar, wind and hydro), solar panels, and lithium batteries.<sup>155</sup> According to the Economist Intelligence Unit, ““for years [China’s] authorities had tolerated expansions in capacity across a variety of industries, despite capacity utilisation rates dipping below 75% (normally a threshold for indicating a balanced relationship between supply and demand).””<sup>156</sup>

72. Excess capacity in China is largely the result of government policies. Key recurring factors include protection of industries by government authorities to support local industrial activity and employment; weak enforcement of regulations; low input prices due to government policies; and fiscal imbalances that incentivize local governments to attract excessive investment.<sup>157</sup>

73. The Chinese government issued several measures in 2016 and 2017 to reduce excess capacity in the coal and steel sectors after the launch of a government initiative termed “supply-side structural reform.” The solutions to excess capacity set forth in the measures continue to reflect a high level of government intervention. Taken together, capacity-shedding measures are top-down directives, not market mechanisms. They entail a high degree of government intervention, while not adequately addressing the root causes of excess capacity or adopting market structures. For example, by setting capacity-shedding targets, the government may under- or overestimate the degree of capacity reduction required to balance supply and demand. In a market-driven process capacity reductions would not cease once an administratively determined level had been reached. Instead, plant closures and market exits would reduce

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<sup>155</sup> *DOC NME Report*, pp. 150-151 (referencing *Guiding Opinions of the State Council on Resolving the Conflict of Rampant Overcapacity*, Article 1 (State Council, Guo Fa [2013], No. 41, issued October 6, 2013); Government of China, NDRC Macroeconomic Studies Institute, “Apply the Method of Reform to Resolve Production Overcapacity,” *Beijing Jingji Ribao Online*, December 13, 2013 (from OSC); *China Development Institute*, “Work Tirelessly to Eliminate Excess Capacity,” April 4, 2016; The Economist Intelligence Unit, *China’s Supply-Side Structural Reforms: Progress and Outlook* (2017), 5, 9) (Exhibit USA-2).

<sup>156</sup> *DOC NME Report*, p. 151 (referencing The Economist Intelligence Unit, *China’s Supply-Side Structural Reforms: Progress and Outlook* (2017), 5) (Exhibit USA-2).

<sup>157</sup> *DOC NME Report*, at p. 151 (referencing European Union Chamber of Commerce in China, *Overcapacity in China: An Impediment to the Party’s Reform Agenda* (2016), 7-14) (Exhibit USA-2).

capacity and employment over time until prices and profits indicated that the capacity and production of firms still in the market was economically viable.<sup>158</sup>

### **b. Financial system distortions**

74. In China’s bank-dominated financial system, the state (at the central and local government levels) maintains and exercises effective control over the vast bulk of banking sector assets. Implicit government guarantees, soft budget constraints, non-arm’s length pricing, and government policy directives fundamentally distort the financial market from both a risk pricing and a resource allocation standpoint.<sup>159</sup>

75. These distortions are directly tied to state ownership and control and to the state’s pervasive and intrusive role in China’s financial system. The state’s explicitly stated goal is to preserve a leading role for the state sector in China’s economy, in general, and in the financial sector, in particular. The state views state-owned banks, at both the central and local government levels, as important government policy instruments, much as it sees state-owned enterprises as instruments (and objects) of state industrial policy.

### **i. Government and Communist Party control over China’s financial institutions**

76. China’s banking sector is the largest in the world, and China’s four largest banks are also the world’s four largest.<sup>160</sup> Although other types of financial institutions are emerging, China’s financial sector remains bank-dominated<sup>161</sup> and those banks are largely state-owned and directed.<sup>162</sup> In addition, state-owned banks, including the People’s Bank of China (PBoC), are

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<sup>158</sup> *DOC NME Report*, at pp. 154-155 (referencing European Union Chamber of Commerce in China, *Overcapacity in China: An Impediment to the Party’s Reform Agenda* (2016), 16-18) (Exhibit USA-2).

<sup>159</sup> U.S. Department of Commerce, “Review of China’s Financial System Memorandum,” Docket C-570-054 (August 1, 2017), pp. 8, 12-16 (noting that even though the government nominally removed the last remaining control on lending and deposit rates at the end of 2015, an analysis of interest rate dynamics suggests that interest rates are not yet market-determined) (“*DOC Financial System Report*”) (Exhibit USA-3).

<sup>160</sup> *DOC Financial System Report*, p. 4 (Exhibit USA-3).

<sup>161</sup> *DOC Financial System Report*, p. 4 (noting that for example, bank loans in the first quarter of 2016 were 142 percent of GDP, compared to 79 percent for “shadow banking” loans, 23 percent for net corporate bond financing, and 7 percent for non-financial enterprise equity) (Exhibit USA-3).

<sup>162</sup> See *DOC NME Report*, p. 168, and *DOC Financial System Report*, p. 5 (noting that the banking sector can be divided into the following parts: five large commercial banks (the “Big Five”) that are majority state-owned, operate large branch networks on a nationwide basis, and accounted for approximately 40 percent of bank assets in 2015; 12 joint-stock commercial banks (JSBs) that operate with generally lower levels of direct government ownership, operate on a nationwide basis, and accounted for approximately 19 percent of bank assets in 2015; approximately 145 city commercial banks and credit unions that generally remain under local government control, serve local markets, and accounted for approximately 14 percent of bank assets in 2015; three wholly state-owned policy banks that focus on infrastructure, agriculture and rural development, and foreign trade, respectively, and accounted for

not independent of the Chinese Communist Party. As discussed earlier, the Chinese Communist Party’s control extends to decisions about financial activity, including where to direct large loans.<sup>163</sup> The CCP’s Organization Department appoints executive officials in state-owned banks and financial institutions.<sup>164</sup>

77. Fitch Ratings reported that “‘Banks Follow State Directives’” finding that “‘China’s commercial banks . . . are still expected to support policy objectives and align their strategies with the State’s broad economic goals, and are frequently urged to do so. That suggests China remains a centrally planned economy despite financial reforms and effort at rebalancing the economy that had implied a greater role for market forces.’”<sup>165</sup> Indeed, the PBoC meets frequently with large banks to ensure that their lending decisions align with the PBoC and government objectives.<sup>166</sup> PBoC “window guidance” on where (and where not) to direct credit is industry- and sometimes firm-specific.<sup>167</sup>

## ii. Loan pricing and credit allocation distortions

78. In China, large banks lend primarily to large, state-owned enterprises.<sup>168</sup> The result is that, in the case of many loans, both the lenders and the borrowers are state-owned and -controlled. State-ownership in the banking sector allows the state to use the banking sector as a key policy instrument to allocate capital to priority industries.<sup>169</sup>

79. The state as lender and borrower leads to significant distortions in lending decisions. Implicit government guarantees on loans made by state-owned banks to SOEs are a consequence

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approximately 10 percent of bank assets in 2015; and foreign-owned banks and bank branches that accounted for 2 percent of bank assets in 2015, unchanged from 2006) (Exhibit USA-3).

<sup>163</sup> *DOC Financial System Report*, p. 6 (referencing Elliott, Douglas and Yan, Kai, “The Chinese Financial System: An Introduction and Overview,” *The Brookings Institution*, John L. Thornton China Center Monograph Series Number 6, July 2013, p. 11) (Exhibit USA-3).

<sup>164</sup> *DOC Financial System Report*, p. 6 (referencing Elliott, Douglas and Yan, Kai, “The Chinese Financial System: An Introduction and Overview,” *The Brookings Institution*, John L. Thornton China Center Monograph Series Number 6, July 2013, p. 11) (Exhibit USA-3).

<sup>165</sup> *DOC Financial System Report*, p. 7 (referencing Chen, Katie, and Wu, Grace, “China: State Support for Banks Intact Amid Financial Reforms,” *Fitch Ratings*, January 8, 2016, p. 1) (Exhibit USA-3).

<sup>166</sup> *DOC Financial System Report*, p. 7 (referencing Shevlin, Aidan, and Wu, Lan, “China: The Path to Interest Rate Liberalization,” *J.P. Morgan Asset Management*, 2015, p. 7) (Exhibit USA-3).

<sup>167</sup> *DOC Financial System Report*, p. 7 (referencing, “Bailing China ‘In’ to the Great State Refinancing,” *PRC Macro*, February 19, 2016, p. 3.) (Exhibit USA-3).

<sup>168</sup> *DOC Financial System Report*, p. 7 (referencing Elliott, Douglas and Yan, Kai, “The Chinese Financial System: An Introduction and Overview,” *The Brookings Institution*, John L. Thornton China Center Monograph Series Number 6, July 2013, p. 3) (Exhibit USA-3).

<sup>169</sup> *DOC Financial System Report*, p. 7 (Exhibit USA-3).

of state ownership and the strategic importance the government attaches to SOEs.<sup>170</sup> Government assumption of the risk on these loans incentivizes both state-owned and non-state-owned banks to lend to SOEs, even if it is clear over time that SOEs are not putting the funds to best (or even productive) use.<sup>171</sup> Perhaps more importantly, these implicit government guarantees remove banks, to a large extent, from the essential business of effectively assessing, pricing, and managing risk.<sup>172</sup> As a result, banks also do not have incentive or capacity to effectively price risk.<sup>173</sup> Consequently, from a system-wide resource allocation standpoint, banks lend inappropriately to SOEs. At the same time, the lack of effective risk pricing encourages imprudent borrowing and investment on the part of SOEs.

80. Soft budget constraints (*i.e.*, the lack of any meaningful budget constraint that makes a company responsible for its own investment or production losses because the company receives financial assistance or support to cover those losses on an ongoing basis) are another consequence of state-ownership and control and the policy role banks play. Soft budget constraints exacerbate the problems of implicit guarantees and moral hazard by insulating SOE managers from the consequences of bad or imprudent production and investment decisions, which have been a major source of vulnerability.<sup>174</sup>

81. China's banking sector continues to over allocate resources to SOEs, providing half of total bank credit, even though they are on the whole the most indebted and least productive enterprises in China, accounting for only 16 percent of value added.<sup>175</sup> Credit allocation has also been driven in large part by continued financing to non-viable companies in industries with over-capacity.<sup>176</sup> The share of loans going to firms with low debt-service capacity is increasing.<sup>177</sup>

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<sup>170</sup> *DOC Financial System Report*, p. 8 (referencing "China Credit: Authorities Have Tools to Avert Financial Crisis, but Erosion of Credit Quality Likely Over the Medium Term," *Moody's Investors Service*, May, 26, 2016, p. 5. See also "China Finance: Power to the Party," *The Economist*, May 5, 2016) (Exhibit USA-3).

<sup>171</sup> *DOC Financial System Report*, p. 8 (referencing "People's Republic of China: Selected Issues," *International Monetary Fund*, IMF Country Report No. 16/271, August 2016, p. 33) (Exhibit USA-3).

<sup>172</sup> *DOC Financial System Report*, p. 8 (referencing "The Financialization of China," *Rhodium Group*, February 2, 2016, p. 3; "Power to the Party," *The Economist*, May 5, 2016. See also "People's Republic of China: Selected Issues," *International Monetary Fund*, IMF Country Report No. 16/271, August 2016, p. 33) (Exhibit USA-3).

<sup>173</sup> *DOC Financial System Report*, p. 8 (referencing "China: Moving Towards a New Monetary Policy Era," *BNP Paribas*, November 4, 2015, p. 2) (Exhibit USA-3).

<sup>174</sup> *DOC Financial System Report*, p. 8 (referencing "Resolving China's Corporate Debt Problem," *International Monetary Fund*, WP/16/203, October 2016, pp. 7, 14) (Exhibit USA-3).

<sup>175</sup> *DOC Financial System Report*, p. 9 (referencing "People's Republic of China: Selected Issues," *International Monetary Fund*, IMF Country Report No. 16/271, August 2016, p. 38) (Exhibit USA-3).

<sup>176</sup> *DOC Financial System Report*, p. 9 (Exhibit USA-3).

<sup>177</sup> *DOC Financial System Report*, p. 9 (Exhibit USA-3).

82. Overall credit growth in China indicates a worsening efficiency of credit allocation,<sup>178</sup> weak governance, forbearance and soft budget constraints, without regard to underlying economic fundamentals that would result in credit tightening.<sup>179</sup>

83. Non-performing loans (NPLs) and special mention loans (SMLs) (loans with which borrowers are experiencing difficulties) have increased rapidly in recent years, and their apparent levels and continued growth suggest the existence of both loan pricing and credit allocation problems. Official figures of NPLs and SMLs, about 5.5 percent of total loans at the end of 2015, appear to significantly understate the full extent of the problem.<sup>180</sup> The reasons for this include debt rollovers and flexible and insufficiently forward-looking loan classification standards.<sup>181</sup> The IMF estimates a loans-potentially-at-risk rate, an indicator of potential trouble ahead, of 15 percent or more.<sup>182</sup> These are loans held by companies with insufficient income before taxes to cover their interest obligations.

### iii. Interest rate controls

84. As recently as 2013, the PBoC set benchmark lending (and deposit) rates on an administrative basis, as well as floors (ceilings) under (above) which banks could not set their loan (deposit) rates. As a result, banks were not incentivized to price their product to ensure

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<sup>178</sup> The U.S. Department of Commerce also reviewed “shadow banking” practices typically understood as credit intermediation involving entities and activities outside the regular or formal banking sector. In China, shadow banking largely consists of loans made by non-bank financial institutions that are predominantly state-owned. These entities lend to local government financing vehicles with inadequate risk pricing. Much of shadow banking in China is formal bank channel lending flowing or spilling over into the informal finance channel because of binding regulatory constraints that limit the flow of loans in the formal bank channel much more than they limit the flow of loans in the informal channel. Roughly two-thirds of shadow banking is effectively “bank loans in disguise.” See *DOC Financial System Report*, pp. 16-21 (Exhibit USA-3).

<sup>179</sup> *DOC Financial System Report*, at 10 (referencing “People’s Republic of China: 2016 Article IV Consultation – Press Release; Staff Report; and Statement by the Executive Director for the People’s Republic of China,” *International Monetary Fund*, IMF Country Report No. 16/270, August 2016, p. 9; Global Financial Stability Report, *International Monetary Fund*, April 2016, p. 17; “China Finance: Banks Breaking Bad,” *The Economist*, May 7, 2016) (Exhibit USA-3).

<sup>180</sup> *DOC Financial System Report*, p. 10 (referencing “Global Financial Stability Report,” *International Monetary Fund*, April 2016, p. 14) (Exhibit USA-3).

<sup>181</sup> *DOC Financial System Report*, p. 10 (referencing “People’s Republic of China: 2016 Article IV Consultation – Press Release; Staff Report; and Statement by the Executive Director for the People’s Republic of China,” *International Monetary Fund*, IMF Country Report No. 16/270, August 2016, p. 20; “Breaking Bad,” *The Economist*, May 7, 2016; Bedford, Jason, “Are We Through the Worst of the Credit Cycle: What the Banks Tell Us,” *UBS*, November 1, 2016, p. 1) (Exhibit USA-3).

<sup>182</sup> *DOC Financial System Report*, p. 11 (referencing “Resolving China’s Corporate Debt Problem,” *International Monetary Fund*, WP/16/203, October 2016, p. 4) (Exhibit USA-3). The IMF estimate likely underestimates the full scope of the problem. The estimate above does not include a large share of the rapidly growing shadow bank lending (discussed below), where credit risk is generally higher than in the formal banking sector and perhaps one-half of shadow banking products poses an elevated risk of default and loss. *DOC Financial System Report* at 11 (Exhibit USA-3).

business success and their own economic viability because the minimum mark-up did that for them.<sup>183</sup> Banks were incentivized to lend past the point where normal market prudential concerns would dictate they slow or stop the flow of funds, since the minimum mark-up remained fixed and independent of loan volume. Third, banks were conditioned to view loan pricing as more an administrative process and less a market process. Banks did not collect and analyze credit and market data to price risk because there was no need to.<sup>184</sup> Loans to the largest bank clients (SOEs) were at least implicitly guaranteed, and that banks' long-held and well-founded expectations were that they were either too big or too important to fail.

85. The PBoC removed formal interest rate controls in two phases: the lending rate floor was removed in July 2013 and deposit rate caps removed in October 2015. However, the PBoC continues to publish benchmark deposit and lending rates, which are now referred to as “reference rates.”<sup>185</sup> In practice, banks continue to follow the government's set reference rates.<sup>186</sup> According to Fitch Ratings, “[t]he removal of the cap on Chinese banks' deposit rates reinforces the authorities' commitment towards financial reform, but will have no meaningful impact on deposit rates in the near term.”<sup>187</sup> Indeed, actual deposit rates are still closely tied to the benchmark deposit rate,<sup>188</sup> and since benchmark deposit rates are well below market-clearing levels,<sup>189</sup> actual deposit rates are also still well below market-clearing levels. Fitch Ratings stated further that although “greater financial liberalization is a positive market development . . . we hold to our view that Chinese banks may still be bounded by regulatory guidance.”<sup>190</sup>

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<sup>183</sup> *DOC Financial System Report*, p. 13 (referencing “China 2030: Building a Modern, Harmonious, and Creative Society,” *The World Bank*, 2013, p. 119) (Exhibit USA-3).

<sup>184</sup> *DOC Financial System Report*, p. 13 (Exhibit USA-3).

<sup>185</sup> *DOC Financial System Report*, p. 13 (referencing “China Deposit Cap Removal – Little Impact on Bank Margins,” *Fitch Ratings*, October 27, 2015; Dong, Jinyue, and Xia, Le, “China: Looking for New Monetary Policy Tools in the Liberalized-Interest-Rate Environment,” *Banco Bilbao Vizcaya Argentina (BBVA)*, February 2016, p. 2) (Exhibit USA-3).

<sup>186</sup> A recent PBoC working paper found that benchmark deposit and loan rates remain the primary basis for pricing deposits and loans. *DOC Financial System Report*, 13 (referencing Jun, Ma, Min, Ji, Muhong, Niu, and Xiang, Zhang, “Transmission of Monetary Policy Via the Banking System,” *The People's Bank of China*, Working Paper No. 2016/4, April 8, 2016, p. 6) (Exhibit USA-3).

<sup>187</sup> *DOC Financial System Report*, p. 14 (referencing “China Deposit Cap Removal – Little Impact on Bank Margins,” *Fitch Ratings*, October 27, 2015) (Exhibit USA-3).

<sup>188</sup> *DOC Financial System Report*, p. 14 (Exhibit USA-3).

<sup>189</sup> *DOC Financial System Report*, p. 14 (referencing “OECD Economic Surveys: China,” *Organization for Economic Co-operation and Development*, March 2015, p. 17 on benchmark deposit rates being below market-clearing levels before controls were removed; “China Lifts Interbank Rates Following Fed Hike,” *Financial Times*, March 15, 2017 on benchmark deposit and lending rates remaining unchanged) (Exhibit USA-3).

<sup>190</sup> *DOC Financial System Report*, p. 14 (referencing “China Deposit Cap Removal – Little Impact on Bank Margins,” *Fitch Ratings*, October 27, 2015) (Exhibit USA-3). In 2013, the PBoC launched the loan prime rate, essentially an average of commercial banks' lending rates to their best clients, in an attempt to establish a reference rate that would encourage market-determined loan pricing. The data indicates that rates continue to cluster closely around the government reference rate. Borrowers that are not state-affiliated may receive loans at rates higher than

86. The distortive effects of PBoC interest rate guidance and administratively set reference rates (past and present) can be seen in the context of the interbank market. The PBoC’s administratively set interest rates remain an important determinant of interbank rates, in terms of both level and volatility.<sup>191</sup> The same is true for (short-term) money market rates (which are one step removed from interbank rates towards the retail end of the market) because the PBoC actually calibrates the liquidity impact of its policy actions to ensure that these rates closely track its own (administratively set) benchmark rates.<sup>192</sup> Not surprisingly, then, the correlation between interbank rates and retail financing rates, specifically loan interest rates, is relatively weak.<sup>193</sup> These findings support what some experts have observed: that “[d]eregulating particular portions of the financial system (in this case interbank rates) does not ensure that those key interest rates can act as independent price signals.”<sup>194</sup>

#### iv. Bond market distortions

87. State-owned and government-linked entities predominate both the supply and demand sides of the bond market. Ninety-four percent of all bonds are issued by government-owned entities,<sup>195</sup> including policy banks, SOEs, local governments, and local government financing vehicles (LGFVs).<sup>196</sup> SOEs and LGFVs have issued an estimated 94 percent of the corporate bonds outstanding, including shorter-dated instruments such as commercial bills and medium-term notes.<sup>197</sup> With commercial banks holding over 60 percent of all bonds and over 70 percent

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the reference rate, but SOEs and other state-linked borrowers continue to have access to credit near the reference rate, because of the implicit government guarantees they enjoy. *DOC Financial System Report*, 14-15 (Exhibit USA-3).

<sup>191</sup> *DOC Financial System Report*, p. 15 (referencing Porter, Nathan and Xu, Tengting, “Money-Market Rates and Retail Interest Regulations in China: The Disconnect Between Interbank and Retail Credit Conditions,” *International Journal of Central Banking*, March 2016, p. 143) (Exhibit USA-3).

<sup>192</sup> *DOC Financial System Report*, p. 16 (referencing “People’s Republic of China: Selected Issues,” *International Monetary Fund*, IMF Country Report No. 16/271, August 2016, p. 13) (Exhibit USA-3).

<sup>193</sup> *DOC Financial System Report*, p. 16 (referencing Jun, Ma, Min, Ji, Muhong, Niu, and Xiang, Zhang, “Transmission of Monetary Policy Via the Banking System,” *The People’s Bank of China*, Working Paper No. 2016/4, April 8, 2016, p. 6) (Exhibit USA-3). The paper also finds that banks remain reluctant to price loans and deposits on the basis of interbank rates, citing excessive volatility of short-term interest rates, the high reserve requirement ratio, the cap of the loan-to-deposit ratio, and other quantitative restrictions on lending as contributing factors. *Ibid.*

<sup>194</sup> *DOC Financial System Report*, p. 16 (referencing Porter, Nathan and Xu, Tengting, “Money-Market Rates and Retail Interest Regulations in China: The Disconnect Between Interbank and Retail Credit Conditions,” *International Journal of Central Banking*, March 2016, p. 145) (Exhibit USA-3).

<sup>195</sup> *DOC Financial System Report*, p. 22 (Exhibit USA-3).

<sup>196</sup> *DOC Financial System Report*, p. 22 (referencing “China Local Governments Revive Off-Budget Fiscal Stimulus,” *Financial Times*, September 21, 2016) (Exhibit USA-3).

<sup>197</sup> *DOC Financial System Report*, p. 22 (referencing Ho, Kenneth, Tang, MK, Tang, Hao, and Wei, Maggie, “China’s Domestic Bond Market,” Goldman Sachs, September 21, 2015, p. 9) (Exhibit USA-3).

of Treasury bonds,<sup>198</sup> government-owned entities account for the majority of bond holdings. Experts believe banks will remain the primary buyers of local government bonds in the near-term.<sup>199</sup>

88. The fact that the parties on both sides of a bond sale are often state-owned or state-linked entities raises concerns about the possibility of non-arm's length relationships and "aligned interests" among the parties that do not characterize market-determined transactions.

89. Implicit government guarantees do not necessarily raise market-distortion concerns. An implicit guarantee on a loan to a single company that simply shifts risk to the government might just be viewed as a subsidy to that company. But implicit government guarantees in China are not isolated; they are pervasive. Implicit guarantees, by removing any incentive for parties to recognize, price and manage risk, encourage them instead to see bond purchases and sales purely in paperwork or administrative terms, rather than as market transactions requiring careful consideration of economic and financial factors. In doing so, pervasive guarantees have over time materially impacted the market's *capacity* to price risk. Market participants did not develop either the data or knowhow necessary to price risk simply because there was no need to. According to a recent IMF report, "the prevalence of implicit state guarantees prevents the appropriate (usually countercyclical) pricing of credit risk in the bond market and distorts credit allocation."<sup>200</sup>

### **c. Land and labor**

#### **i. State ownership and land market distortions**

90. Private land ownership is prohibited in China. All land is owned by some level of government, the distinction being between rural land owned by the local government or "collective" at the township or village level (referred to as "collectively owned"), and urban land owned by the national government (referred to as "state-owned").<sup>201</sup> After 1978, the Chinese government separated land ownership from the right to use land, in an attempt to introduce productivity incentives.<sup>202</sup> Although the Chinese government has established a legal framework for land-use rights, significant restrictions remain with respect to the scope, tenure, and security

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<sup>198</sup> *DOC Financial System Report*, p. 23 (referencing Sambor, JC, and Sanker, Kevin, "China Spotlight: Onshore Bond Market: Where to from Here?" *Institute of International Finance*, April 27, 2016, p. 6) (Exhibit USA-3).

<sup>199</sup> *DOC Financial System Report*, p. 23 (referencing "China's Bond Markets – The Start of a Golden Age," *Standard Chartered*, February 29, 2016, p. 22) (Exhibit USA-3).

<sup>200</sup> *DOC Financial System Report*, 24 (referencing "People's Republic of China: Selected Issues," *International Monetary Fund*, IMF Country Report No. 16/271, August 2016, p. 14) (Exhibit USA-3).

<sup>201</sup> *DOC NME Report*, p. 95 (Exhibit USA-2).

<sup>202</sup> For more details on the history of land use rights, see *DOC NME Report*, pp. 95-96 (Exhibit USA-2).



of such rights. These restrictions together with the government’s underlying ownership allow distortions into the price and use of land.

91. A particularly important restriction is that individual holders of rural land-use rights – also referred to as “contracting rights” – cannot convert collectively owned rural land into state-owned urban land. Collectively owned rural land may only be “leas[ed] out to land users with due compensation” once that land has been “requisitioned and turned into state-owned land.”<sup>203</sup> In turn, when rural land-use rights are revoked and the land is converted for urban use, the compensation provided is often inadequate and inconsistently administered.<sup>204</sup>

92. Moreover, with respect to urban state-owned land, the *Land Administration Law of the People’s Republic of China* provides that any entity or individual seeking land for construction must apply for approval from the government, the formal owner of state-owned land.<sup>205</sup> The Chinese government classifies land-use rights for state-owned urban land as either “granted” or “allocated,” depending on how the government confers the use rights.<sup>206</sup> When use rights are “granted,” they are effectively leased by the government in return for a payment.<sup>207</sup> In addition to paying the government for the right to use the land, the party receiving the urban land-use right is required to use the land in accordance with the terms and use purposes set forth in a contract signed with the relevant municipal- or county-level government department in charge of land administration.<sup>208</sup>

93. Furthermore, the central government sets an annual national quota for the conversion of arable land for construction and distributes the quota to each province. This quota allocation is informed by a long-term plan, for the period 2006-2020, in which the government sets specific targets regarding the quantity of land used for different purposes. The central government’s ability to assign construction quotas by province is thus a powerful tool to influence land use between urban and rural areas, as well as between different regions of the country.<sup>209</sup>

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<sup>203</sup> *DOC NME Report*, p. 98 and accompanying discussion and references (Exhibit USA-2).

<sup>204</sup> *DOC NME Report*, pp. 104-107 (referencing, *inter alia*, World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 76299 (March 23, 2013), 32; World Bank and State Council DRC, “Urban China: Toward Efficient, Inclusive, and Sustainable Urbanization,” *Natural Resources Forum* 39(2) (2014), 41; Dwight Perkins, “China’s Land System: Past, Present, and Future,” in *Property Rights and Land Policies*, eds. Gregory K. Ingram and Yu-Hung Hong (Cambridge, Ma: Lincoln Institute of Land Policy, 2009), 88; Landesa Rural Development Institute, *Summary of 2011 17-Province Survey’s Findings* (April 26, 2012), 2-4) (Exhibit USA-2).

<sup>205</sup> *DOC NME Report*, pp. 100-101 (Exhibit USA-2).

<sup>206</sup> *DOC NME Report*, pp. 100-101 (Exhibit USA-2).

<sup>207</sup> *DOC NME Report*, pp. 100-101 (referencing Li Zhang and Xianxiang Xu, *Land Policy and Urbanization in the People’s Republic of China*, ADBI Working Paper Series No. 614 (Asian Development Bank Institute, November 11, 2016), 5) (Exhibit USA-2).

<sup>208</sup> *DOC NME Report*, pp. 100-101 (Exhibit USA-2).

<sup>209</sup> *DOC NME Report*, pp. 110-112 (referencing *Outline of the National Overall Planning on Land Use (2006-2020)* (State Council, Guo Fa [2008] No. 33, issued October 6, 2008); World Bank and State Council DRC, *Urban China*:

94. This land market segmentation distorts land prices, particularly by driving a wedge between prices in rural and urban areas.<sup>210</sup> Segmented land markets also distort the broader allocation of resources in China’s economy. In fact, the Chinese government has also used its ownership and control over land to support state industrial policies. A 2013 World Bank study finds that one of the defining characteristics of industrial policies in China is to institute ““direct administrative interventions”” to shift resources, including land, from prohibited to preferred sectors.<sup>211</sup> The central government’s ability to assign construction quotas by province is a particularly powerful tool in this regard, as it allows planners to influence the distribution and growth of industry across the country.<sup>212</sup>

95. Central government measures to influence the distribution of industrial assets expressly reference land. For example, the 2005 *State Council Decision on Implementing the Interim Provisions on Promoting the Structural Adjustment of Industry* provide that Chinese authorities “shall speed up the formulation and amendment of policies on . . . land . . . [to] intensify the coordination and cooperation with industrial policies, and further improve and promote the policy system on industrial structure adjustment.”<sup>213</sup> Similarly, the *Guiding Opinions of the State Council on Central and Western Regions’ Undertaking of Industrial Transfer* provides that the annual construction quotas allocated to central and western regions are to be increased, with ““preferential allocation of construction land quotas for industrial parks.””<sup>214</sup>

96. Government fiscal imbalances are a particularly important factor influencing land-use decisions in China. Local governments account for a greater share of total government expenditure than government revenue,<sup>215</sup> largely because they bear primary responsibility for financing public services such as policing, schools, hospitals, and roads.<sup>216</sup> At the same time,

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*Toward Efficient, Inclusive, and Sustainable Urbanization*, Natural Resources Forum 39(2) (2014), 268; Yuan Xiao and Jinhua Zhao, *Fixing China’s Distorted Urban Land Quota System*, Paulson Policy Memorandum (Paulson Institute, March 2015); Siu Wai Wong, “Land Requisitions and State-Village Power Restructuring,” *The China Quarterly* 224 (December 2015): 901 (Exhibit USA-2).

<sup>210</sup> *DOC NME Report*, p. 108 (referencing Yanling Peng et al., *How Farmland Mortgages Could Stimulate Rural Entrepreneurship in China* (Paulson Institute, February 14, 2017), 7) (Exhibit USA-2).

<sup>211</sup> *DOC NME Report*, pp. 111-112 (referencing World Bank and State Council DRC, *China 2030: Building a Modern, Harmonious, and Creative Society*, No. 76299 (March 23, 2013), 142) (Exhibit USA-2).

<sup>212</sup> *DOC NME Report*, pp. 111-112 (referencing Yuan Xiao and Jinhua Zhao, *Fixing China’s Distorted Urban Land Quota System*, Paulson Policy Memorandum (Paulson Institute, March 2015)) (Exhibit USA-2).

<sup>213</sup> *DOC NME Report*, pp. 111-112 (Exhibit USA-2).

<sup>214</sup> *DOC NME Report*, p. 112 (Exhibit USA-2).

<sup>215</sup> *DOC NME Report*, p. 112 (noting that for the year 2015, local governments accounted for 85.5 percent of fiscal outlays, versus 50.2 percent of tax revenue and referencing WTO, *Trade Policy Review – Report by the Secretariat – China*, WT/TPR/S/342 (June 15, 2016), 19) (Exhibit USA-2).

<sup>216</sup> *DOC NME Report*, p. 112 (referencing Athar Hussain and Nicholas Stern, “Public Finances, the Role of the State, and Economic Transformation, 1978-2020,” in *Public Finance in China: Reform and Growth for a*

local governments are constrained in their revenue-raising activities. Pursuant to tax reforms introduced in 1994, the central government collects the majority of fiscal revenue from the two largest tax items – the value-added tax and the corporate income tax<sup>217</sup> – and power to pass tax legislation rests at the central level. Authorities at the sub-province level lack the ability to raise capital through bond issuances.<sup>218</sup> Central government fiscal transfers are designed to plug funding gaps at the local level, but in practice, they do not suffice.<sup>219</sup>

97. Consequently, local governments sell land-use rights in order to meet their fiscal needs, typically following the conversion of collectively owned rural land into state-owned urban land.<sup>220</sup> Revenues from land sales are a primary source of local government revenue.<sup>221</sup> Revenue from land sales as a share of total government revenue fluctuates from year-to-year but was approximately 45 percent in 2013 after reaching a peak of nearly 70 percent in 2010.<sup>222</sup> Land concession income, which is the income local governments receive from leasing the land-use rights, grew from an estimated RMB 588 billion in 2006 to RMB 3.3 trillion in 2013.<sup>223</sup>

## **ii. Distortions caused by China’s internal migration controls and restrictions on labor organizations**

98. Under the *hukou* system administered by the Chinese government, every Chinese citizen since the 1950s has been classified at birth as either an “agricultural” (rural) or “non-agricultural” (urban) resident and registered with a local jurisdiction – a city, town, or village – that is considered his or her official and only place of “permanent residence.” This local *hukou* typically passes from mother to child and entitles the holder to services including education,

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*Harmonious Society*, (eds.) Jiwei Lou and Shuilin Wang (Washington, DC: World Bank, 2008), 13-38)) (Exhibit USA-2).

<sup>217</sup> *DOC NME Report*, p. 112 (referencing WTO, *Trade Policy Review – Report by the Secretariat – China*, WT/TPR/S/342 (June 15, 2016), 19; budget revenue statistics for the year 2015 (Ministry of Finance website, available at <http://yss.mof.gov.cn/2015js/>, accessed September 11, 2017)) (Exhibit USA-2).

<sup>218</sup> *DOC NME Report*, p. 113 (noting that a revised budget law passed in 2014 permits province-level authorities to issue bonds, but this authority does not extend to the sub-province level and referencing Sandra Heep, “Public Finance,” in *China’s Political System*, (ed.) Sebastian Heilmann (New York: Rowman & Littlefield, 2017), 109) (Exhibit USA-2).

<sup>219</sup> *DOC NME Report*, p. 113 (referencing Christine Wong, “Fiscal Reform: Paying for the Harmonious Society,” *China Economic Quarterly* 14(2) (2010): 20-25) (Exhibit USA-2).

<sup>220</sup> *DOC NME Report*, p. 113 (referencing W. Raphael Lam and Philippe Wingender, *China: How Can Revenue Reforms Contribute to Inclusive and Sustainable Growth?*, IMF Working Paper WP/15/66 (IMF, March 2015), 21-22 and Zhu Qian, “Land Acquisition Compensation in Post-Reform China: Evolution, Structure, and Challenges in Hangzhou,” *Land Use Policy* 46 (2015): 251) (Exhibit USA-2).

<sup>221</sup> *DOC NME Report*, at 113 (referencing World Bank and State Council DRC, *Urban China: Toward Efficient, Inclusive, and Sustainable Urbanization*, Natural Resources Forum 39(2) (2014), 267) (Exhibit USA-2).

<sup>222</sup> *DOC NME Report*, p. 113 (Exhibit USA-2).

<sup>223</sup> *DOC NME Report*, p. 113 (Exhibit USA-2).

housing, healthcare, and social welfare provided by the local jurisdiction.<sup>224</sup> Transferring one's *hukou* classification from agricultural to non-agricultural status or changing the place of registration is a difficult bureaucratic process.<sup>225</sup>

99. A key purpose for establishing the *hukou* system under China's command economy was to prevent mass migration to cities.<sup>226</sup> After 1978, rapid economic growth and urban expansion created a demand for labor that was met by migration from rural to urban areas and from central to coastal regions. Over time, the persistence of the *hukou* system has resulted in an acute imbalance: over half of China's population now lives in urban areas, but only one-third of the urban population holds an urban *hukou*.<sup>227</sup>

100. Access to low-cost migrant labor has contributed to China's emergence as a low-cost production center in the global economy. As one scholar has noted, the *hukou* system has created a "huge class of super-exploitable, yet highly mobile or flexible industrial workers for China's new economy, now closely integrated into global trade networks."<sup>228</sup> For example, in China's largest migrant labor city, Shenzhen, often referred to as the "world's factory," local government officials have acknowledged that the city could not have achieved its rapid economic growth without rural migrant labor.<sup>229</sup>

101. Several *hukou*-related factors continue to distort labor markets by limiting labor mobility. First, rural *hukou* holders have shown reluctance to transfer their *hukou* to an urban location because it requires them to relinquish their increasingly valuable rural land-use rights, which in many cases represents the only retirement security that rural residents and their families have.<sup>230</sup> Second, rural residents that migrate outside the geographical area of their *hukou* registration may

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<sup>224</sup> *DOC NME Report*, p. 28 (referencing Kam Wing Chan, "The Chinese Hukou System at 50," *Eurasian Geography & Economics* 50(2) (2009): 201-202 and Charlotte Goodburn, *The End of the Hukou System? Not Yet*, China Policy Institute Policy Paper (China Policy Institute, University of Nottingham, September 2014), 2) (Exhibit USA-2).

<sup>225</sup> *DOC NME Report*, p. 28 (referencing Charlotte Goodburn, *The End of the Hukou System? Not Yet*, China Policy Institute Policy Paper (China Policy Institute, University of Nottingham, September 2014), 3) (Exhibit USA-2).

<sup>226</sup> *DOC NME Report*, p. 28 (referencing Maarten Bosker et al., *Hukou and Highways: The Impact of China's Spatial Development Policies on Urbanization and Regional Inequality*, Policy Research Working Paper WPS7350 (World Bank Group, Development Research Group, June 2015), 7; Charlotte Goodburn, *The End of the Hukou System? Not Yet*, China Policy Institute Policy Paper (China Policy Institute, University of Nottingham, September 2014), 2) (Exhibit USA-2).

<sup>227</sup> *DOC NME Report*, p. 28 (Exhibit USA-2).

<sup>228</sup> *DOC NME Report*, p. 28 (Exhibit USA-2).

<sup>229</sup> *DOC NME Report*, p. 28 (Exhibit USA-2).

<sup>230</sup> *DOC NME Report*, p. 29 (referencing Kam Wing Chan, "The Chinese Hukou System at 50," *Eurasian Geography & Economics* 50(2) (2009): 205; Charlotte Goodburn, *The End of the Hukou System? Not Yet*, China Policy Institute Policy Paper (China Policy Institute, University of Nottingham, September 2014), 6) (Exhibit USA-2).

not have access to public services, healthcare benefits, housing, the educational system and formal employment under a written labor contract.<sup>231</sup>

102. Government proposals to loosen the *hukou* system still have distortive effects. Notably, the State Council’s *Opinion on Hukou Reform* provides that controls be stricter in large cities, particularly mega-cities such as Beijing, Shanghai, and Shenzhen, than in small and medium-sized cities.<sup>232</sup> Restrictions in larger cities make it difficult, if not impossible, for the vast majority of migrants to obtain an urban *hukou* in the urban areas where the best economic opportunities are located. Those migrants and their dependents who still choose to live in the larger cities will continue to face uncertainty regarding access to social services, education and healthcare.<sup>233</sup> Conversely, in the small and medium-sized cities where the Chinese government is relaxing controls on labor flows, economic opportunities are fewer and social services more limited.

103. In addition, China’s *Labor Law* provides that employees may join or organize trade unions and negotiate collective contracts,<sup>234</sup> but Chinese law does not permit workers to organize or join unions not approved by the state. Workers in China also do not have the right to strike under Chinese law.<sup>235</sup>

104. The All-China Federation of Trade Unions (ACFTU) has been China’s official trade union since the founding of the People’s Republic of China in 1949. ACFTU’s legal monopoly on all trade union activities is codified in the *Trade Union Law of the People’s Republic of China* (“*Trade Union Law*”) adopted in 1992, and remains unchanged after amendments to the law in 2001 and 2009.<sup>236</sup> ACFTU is subject to CCP control, and trade union leaders concurrently hold

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<sup>231</sup> *DOC NME Report*, at 29 (referencing Ming Lu and Yiran Xia, *Migration in the People’s Republic of China*, Working Paper No. 593 (ADBI, September 2016), 5-7; Jason Gagnon et al., “Are Migrants Discriminated Against in Chinese Labor Markets?” *IZA Journal of Labor and Development* 3(17) (2014): 9-12) (Exhibit USA-2).

<sup>232</sup> *DOC NME Report*, p. 29 (Exhibit USA-2).

<sup>233</sup> *DOC NME Report*, p. 29 (referencing Charlotte Goodburn, *The End of the Hukou System? Not Yet*, China Policy Institute Policy Paper (China Policy Institute, University of Nottingham, September 2014), 4-5) (Exhibit USA-2).

<sup>234</sup> *DOC NME Report*, p. 20 (Exhibit USA-2).

<sup>235</sup> *DOC NME Report*, p. 20 (referencing Kai Chang and Fang Lee Cooke, “Legislating the Right to Strike in China: Historical Development and Prospects,” *Journal of Industrial Relations* 57(3) (2015): 444 and 448; Dongtao Qi, *Progress and Dilemmas of Chinese Trade Unions*, East Asian Policy Background Brief 537 (East Asian Institute, National University of Singapore, 2010), 21) (Exhibit USA-2).

<sup>236</sup> *DOC NME Report*, p. 20 (Exhibit USA-2).

office at a corresponding rank in the CCP or the government.<sup>237</sup> The current ACFTU chairman is a member of the Chinese Communist Party Politburo.<sup>238</sup>

105. Negotiations between labor and management in China have traditionally been described as “collective consultations,” which are a “formality.”<sup>239</sup> In actuality, either labor and management do not “carry out real bargaining” or “management does not even meet with the trade unions, and just sends them a collective contract for ‘approval.’”<sup>240</sup> This context is at odds with the practice of collective bargaining as envisioned by international institutions such as the ILO, in which trade unions are “legitimate units of bargaining.”<sup>241</sup> When workers cannot freely organize, their ability to bargain freely is reduced and potentially underestimates their true market value.

### 3. Chinese Prices and Costs Are Distorted as a Result of State Control

106. The Chinese government and the Chinese Communist Party’s legal and actual ownership and control over key economic actors and institutions pervades China’s economy, including the largest financial institutions and leading enterprises in manufacturing, energy, and infrastructure. The prevalence of price distortions in China’s economy cannot be understated. Although the Chinese government does not formally set prices directly for most goods and services, it nonetheless exerts a high degree of control over prices it deems essential or strategic.<sup>242</sup> China’s ability to set and guide factor input prices, in particular, results in distorted costs and prices throughout the economy.<sup>243</sup> Thus, notwithstanding an aggregate reduction in China’s direct price

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<sup>237</sup> *DOC NME Report*, p. 20 (referencing Rudolf Traub-Merz, *All China Federation of Trade Unions: Structure, Functions and the Challenge of Collective Bargaining*, Working Paper No. 13 (International Labor Office, Global Labour University, September 2011), 8) (Exhibit USA-2).

<sup>238</sup> *DOC NME Report*, p. 20 (referencing Rudolf Traub-Merz, *All China Federation of Trade Unions: Structure, Functions and the Challenge of Collective Bargaining*, Working Paper No. 13 (International Labor Office, Global Labour University, September 2011), 8; “ACFTU Leadership” on ACFTU website, available at <http://en.acftu.org/28589/201408/15/140815173447455.shtml>, accessed September 13, 2017) (Exhibit USA-2).

<sup>239</sup> *DOC NME Report*, p. 26 (referencing Chris King-Chi Chan and Elaine Sio-leng Hui, “The Development of Collective Bargaining in China: From ‘Collective Bargaining by Riot’ to ‘Party State-Led Wage Bargaining,’” *China Quarterly* 217 (March 2014): 226) (Exhibit USA-2).

<sup>240</sup> *DOC NME Report*, pp. 26-27 (Exhibit USA-2).

<sup>241</sup> *DOC NME Report*, pp. 26-27 (referencing ILO, *International Labor Standards on Collective Bargaining* (2017); ILO, *International Labor Standards on Freedom of Association* (2017); Bernard Gernigon *et al.*, *ILO Principles Concerning the Right to Strike* (ILO, 1998), 3; Chris King-Chi Chan and Elaine Sio-leng Hui, “The Development of Collective Bargaining in China: From ‘Collective Bargaining by Riot’ to ‘Party State-Led Wage Bargaining,’” *China Quarterly* 217 (March 2014): 227) (Exhibit USA-2).

<sup>242</sup> *DOC NME Report*, p. 158 (Exhibit USA-2).

<sup>243</sup> *DOC NME Report*, p. 6 (Exhibit USA-2). Reports by international institutions such as the Asian Development Bank have pointed to significant price distortions in China’s economy, particularly in factor markets. *DOC NME Report*, p. 158 (Exhibit USA-2).

controls, the remaining controls, especially as applied to factor inputs, influence costs and prices throughout China’s industry-intensive economy.<sup>244</sup>

107. China remains, therefore, a non-market economy. The Chinese government continues to maintain and exercise broad discretion and control to allocate resources with the goal of achieving specific economic outcomes. This system distorts costs and prices throughout China’s economy, such that non-market conditions continue to prevail in the operation of China’s economy. Given the extent of China’s non-market economic distortions, China’s position in this dispute – that Members would be prohibited from rejecting and replacing prices or costs that are not determined under market economy conditions for purposes of anti-dumping comparisons – would expose other Members even more to those economic distortions. This would undermine a fundamental right of all Members of the WTO to address non-market economy distortions.

#### **IV. PROPERLY INTERPRETED, WTO TEXTS PROVIDE MEMBERS THE AUTHORITY TO REJECT AND REPLACE PRICES AND COSTS THAT ARE NOT MARKET-DETERMINED FOR PURPOSES OF ANTI-DUMPING COMPARISONS UNDER ARTICLE VI OF GATT 1994 AND ARTICLE 2 OF THE ANTI-DUMPING AGREEMENT**

108. The United States submitted an extensive legal interpretation on November 13, 2017, interpreting GATT 1994 Article VI:1, the Second Note *Ad* Article VI:1 of GATT 1994, practice of the Contracting Parties in the application of Article VI, the GATT accessions of Poland, Romania, and Hungary, Article 2 of the Anti-Dumping Agreement, and Section 15 of China’s Protocol of Accession. As demonstrated through that interpretation, the evidence is overwhelming that WTO Members have not surrendered their longstanding rights in the GATT and WTO to reject prices or costs that are not determined under market economy conditions in determining price comparability for purposes of anti-dumping comparisons. The United States incorporates that legal interpretation as an integral part of this submission.

109. We have reproduced that legal interpretation verbatim as Attachment 1 to this submission and respectfully request the Panel to refer to that interpretation. For the convenience of the Panel, we reproduce here solely the executive summary of the interpretation. In the next Section V, we apply this legal interpretation to China’s claims.<sup>245</sup>

110. Reading the text of Article VI:1 of GATT 1994, Section 15 of China’s Accession Protocol, the Second Note *Ad* Article VI:1, GATT accession documents, and other texts leads to the conclusion that GATT Contracting Parties and WTO Members have always recognized that non-market prices or costs are not suitable for anti-dumping comparisons because they are not appropriate to use “in determining price comparability”. In an anti-dumping determination, it is necessary to ensure comparability between the normal value and the export price; and

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<sup>244</sup> *DOC NME Report*, p. 158 (Exhibit USA-2).

<sup>245</sup> U.S. Third-Party Submission, Attachment 1 (Section 1: Executive Summary).

comparability is only ensured when the comparison between the normal value and the export price is capable of producing a meaningful answer to the question of whether or not there is dumping as defined by Article VI of the GATT 1994 and the Anti-Dumping Agreement. In this respect, Members have always recognized that non-market prices or costs are distorted and unreliable, and thus are not suitable for anti-dumping comparisons. These non-market prices and costs do not constitute or give rise to “comparable prices, in the ordinary course of trade,” and therefore they are not appropriate to use “in determining price comparability”.

111. In Section 15(a) of China’s Accession Protocol, WTO Members and China adopted this longstanding approach and clarified that, so long as prices and costs in China continued not to be determined under market economy conditions, its domestic prices and costs would be considered distorted in determining price comparability under GATT 1994 Article VI and the Anti-Dumping Agreement and may be rejected. The resulting text reflects the understanding of WTO Members that anti-dumping duties would remain an appropriate response and that domestic prices or costs would not be suitable where market economy conditions did not prevail.

112. The basic requirement of comparability, which predates Section 15, flows from Article VI of GATT 1994, and is further reflected in the Second Note *Ad* Article VI:1 and in Article 2 of the Anti-Dumping Agreement. Understood correctly, Article VI establishes that the dumping comparison requires comparable, market-determined prices. Without a “comparable price, in the ordinary course of trade”, no dumping comparison can be made. This “comparable price, in the ordinary course of trade” is a market-determined price. Accordingly, Section 15(a)(i) clarifies the view of WTO Members that it is appropriate to use domestic prices or costs in determining price comparability if “market economy conditions prevail” in the industry under investigation. For purposes of a dumping comparison, both Section 15 and Article VI call for “comparable prices” that are market-determined to determine normal value.

113. This understanding is confirmed by the Second Note *Ad* GATT 1994 Article VI:1. The Second Note also reflects that it is the definition in Article VI:1, together with Article VI:2, that provides for the legal authority to reject non-market prices and costs in anti-dumping comparisons, not the Second Note itself. The Second Note confirms that, under GATT 1994 Articles VI:1 and VI:2, an importing Member must “determin[e] price comparability for the purposes of paragraph 1” of Article VI. That is, to make a dumping comparison, the importing Member must ensure comparability by finding “comparable prices” to establish normal value. The Second Note identifies *one* situation (a state-controlled economy) in which “special difficulties may exist in determining price comparability,” but there is no text suggesting this is the *exclusive* situation in which “special difficulties may exist”. The recognition by Members of a “case” creating special difficulties does not logically imply that there could be no other “case”. The Second Note is not written as an *exception* to Article VI and the text does not provide legal *authority* to do something that an importing Member may not already do or is prohibited from



doing. Rather, the GATT CONTRACTING PARTIES,<sup>246</sup> through an “interpretative note”, recognized that the authority to reject domestic prices when these are not “comparable prices, in the ordinary course of trade” lies in Article VI.

114. The GATT Secretariat’s review of Contracting Parties’ legislation applying Article VI provides further evidence confirming the understanding of Article VI as requiring market-determined prices for determining price comparability. This review of legislation and practice also evidences subsequent practice in the application of Article VI establishing the agreement of the parties regarding its interpretation. The Contracting Parties’ legislation confirms their understanding that ensuring price comparability under Article VI requires a market-determined normal value – that is, a comparable price, in the ordinary course of trade. The report acknowledges the core view of Contracting Parties that “a lack of comparable figures” (prices and costs) in non-market economies means that normal value must be found on another basis – e.g., on the basis of prices in third countries. The report also observes that the Contracting Parties continued to apply Article VI in a manner that demonstrated they considered they had the legal authority to calculate normal value on the basis of market-determined prices (e.g., third-country prices) when non-market economic conditions rendered domestic prices or costs unsuitable for establishing a normal value and ensuring comparability.

115. The practice of GATT Contracting Parties in accessions to the GATT, and the agreements reached in those accessions, confirms that non-market economy prices and costs may be rejected pursuant to Articles VI:1 and VI:2 of GATT 1994. In the accessions of Poland, Romania, and Hungary to the GATT, the Contracting Parties did not create any exception to Article VI:1 of GATT 1994 in the accession protocol of the acceding non-market economy. Rather, in each case they re-affirmed their ability to reject and replace non-market prices or costs for anti-dumping comparisons. The subsequent practice of the Contracting Parties supports the interpretation of Articles VI:1 and VI:2 as providing the legal authority to ensure comparability and to reject prices and costs not determined under market economy conditions for purposes of anti-dumping comparisons.

116. The Anti-Dumping Agreement, through Article 2, implements the principle of comparability set forth in Article VI of GATT 1994. In relation to determining comparability, the Anti-Dumping Agreement confirms that establishing normal value requires a comparable, market-determined price or costs that ensures comparability. Article 2.1 retains the key elements from Article VI for domestic prices to be used to calculate normal value – that is, there must be a “comparable price, in the ordinary course of trade.” Thus, as under Article VI, the lack of comparable, market-determined prices – that is, determined under market economy conditions for the industry under investigation – requires the use of an alternative source for normal value. Similarly, non-market-determined costs (the prices of production factors) are distorted or unreliable and cannot ensure comparability (as through prices in the ordinary course of trade).

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<sup>246</sup> Consistent with Article XXV:1 of the GATT 1994, this document uses “CONTRACTING PARTIES” to mean “the contracting parties acting jointly.”

Article 2.2 reinforces the proposition that normal value must be based on prices and costs that permit a “proper comparison”. The prices or costs of an industry in which market economy conditions do not prevail cannot be considered comparable prices, or capable of ensuring comparability, for purposes of “normal value.” In sum, Article 2 of the Anti-Dumping Agreement confirms the principle of comparability expressed in Article VI:1 of GATT 1994.

117. Section 15, in turn, is a specific expression of the principle that comparability needs to be ensured. Section 15 is concerned with “determining price comparability *under* Article VI of the GATT 1994 and the Anti-Dumping Agreement”. The primary “rules” for determining price comparability would be those in the two agreements. The provisions of Section 15 do not cover all situations and do not need to as Article VI of GATT 1994 and the Anti-Dumping Agreement also govern the determination of price comparability. Thus, the expiry of subparagraph (a)(ii) of Section 15 does not mean that an importing Member may not ensure comparability under Article VI of the GATT 1994 and the Anti-Dumping Agreement for purposes of making a dumping comparison. Rather, expiry of subparagraph (a)(ii) means that the “rule” set out in that provision does not apply beyond 15 years. Nothing in Section 15(d) suggests a lapse in the basic requirement to ensure comparability, which flows from Article VI:1 of the GATT 1994, as implemented particularly in Article 2 of the Anti-Dumping Agreement. If market economy conditions do not prevail in China or in the industry or sector under investigation, then “comparable” prices or costs do not exist for purposes of the dumping comparison. In that situation, an importing Member may use a methodology that is not based on a strict comparison with domestic prices or costs in China.

118. In sum, the expiry of one provision of China’s Accession Protocol, Section 15(a)(ii), does not mean that WTO Members no longer have the ability to reject and replace non-market domestic prices or costs for purposes of anti-dumping comparisons. Rather, the legal authority to reject prices or costs not determined under market economy conditions flows from GATT 1994 Articles VI:1 and VI:2. That this authority exists in Article VI is reflected in legal text and consistent practice spanning decades: the proposal to amend Article VI:1 and eventual adoption of the Second Note *Ad* Article VI:1 (1954-55), confirming the legal authority existed in Article VI; the Secretariat review of Contracting Parties’ application of Article VI, demonstrating a subsequent, common practice rejecting non-market prices or costs in determining normal value (1957); the Accessions to the GATT of three non-market economies – Poland (1967), Romania (1971), and Hungary (1973) – in which the CONTRACTING PARTIES affirmed their existing ability to reject non-market prices or costs in situations other than “the case” described in the Second Note; Article 2 of the Anti-Dumping Agreement (1995), bringing forward the key concepts from Article VI:1 and reinforcing (through terms such as “proper comparison”) that market-determined prices or costs are necessary for anti-dumping comparisons; and Section 15 (2001), which clarifies that domestic prices or costs will be used when “market economy conditions prevail” for the industry under investigation, but domestic prices or costs may be rejected when market economy conditions do not prevail.

119. The evidence is overwhelming that WTO Members have not surrendered their longstanding rights in the GATT and WTO to reject prices or costs that are not determined under market economy conditions in determining price comparability for purposes of anti-dumping comparisons.

**V. CHINA’S CLAIMS FAIL BECAUSE IT HAS MISUNDERSTOOD THE RELEVANT WTO TEXTS AND IGNORED THE NEED FOR COMPARABLE, MARKET-DETERMINED PRICES AND COSTS FOR PURPOSES OF ANTI-DUMPING COMPARISONS**

**A. The Measure at Issue Does Not Breach Articles 2.1 or 2.2 of the Anti-Dumping Agreement or Article VI:1 of the GATT 1994**

120. China argues that, 15 years following China’s accession, WTO Members have no legal basis to reject domestic prices or costs and instead use market-determined prices or costs to determine normal value for purposes of dumping comparisons.<sup>247</sup> China is wrong on the law and the facts because it has failed to properly interpret all of the relevant WTO texts. As demonstrated through the legal interpretation in Attachment 1 to this submission, WTO Members have not surrendered their longstanding rights in the GATT and WTO to reject prices or costs that are not determined under market economy conditions in determining price comparability.

**1. Contrary to China’s argument, WTO Members have long understood that the legal authority to reject prices or costs not determined under market economy conditions flows from Articles VI:1 and VI:2 and is further reflected in the Second Note and Article 2**

121. China erroneously argues that Articles 2.1 and 2.2 of the Anti-Dumping Agreement and Article VI:1 of the GATT 1994 “do not permit the use of surrogate country prices and costs to determine normal value,” and that the only provision that does so is the Second Note.<sup>248</sup> China considers that “[t]he list of circumstance in Article 2.2 for departing from the use of home market prices is an *exclusive* list” and that “[a]n authority . . . may not depart from using home market prices as the basis for normal value . . . unless one of the specified circumstances is present.”<sup>249</sup> China considers that “Article VI:1 describes the same universe of normal methodologies that are contemplated in Articles 2.1 and 2.2 of the *Anti-Dumping Agreement*”<sup>250</sup> and therefore VI:1(b)(1) and (2) are exclusive alternative methodologies. Finally, China also mistakenly asserts that the Second Note is the only legal provision that “permits an investigating

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<sup>247</sup> China’s First Written Submission, paras. 4, 65-73, 76, 82, 133-183.

<sup>248</sup> China’s First Written Submission, paras. 133-134.

<sup>249</sup> China’s First Written Submission, para. 142 (emphasis original).

<sup>250</sup> China’s First Written Submission, para. 154 (emphasis original).

authority, on a conditional basis, to determine normal value using a methodology that is not based on a strict comparison with domestic prices and costs.”<sup>251</sup>

122. *Every step of China’s approach is flawed because it fails to engage with the text. In particular, China does not provide any interpretation of the key phrase “comparable price, in the ordinary course of trade,” that underlies the dumping comparison in Article VI and Articles 2.1 and 2.2. China does not consider the practice and history relating to the Contracting Parties’ application of Article VI. China does not consider the specific text of the Second Note, and therefore fundamentally misunderstands this provision as providing legal authority to reject non-market prices and costs. China also does not consider the text of Section 15 and its references to “determining price comparability” and examining whether market economy conditions prevail in an investigated industry – instead simply asserting that Section 15(a) has expired. In each of the latter cases (the alleged authority provided by the Second Note and the alleged expiry of Section 15(a)), instead of reading the WTO texts carefully, China prefers to rely on dicta appearing in previous Appellate Body reports. But those appeals did not involve the Second Note or Section 15(d), and such report language cannot supersede or undermine the actual text agreed by Members, including China.*

123. Drawing on the legal interpretation set out as Attachment 1, the United States below demonstrates that China’s claims under Articles 2.1 and 2.2 and Article VI are based on a misunderstanding of the relevant legal texts. China simply misunderstands that a dumping comparison requires the use of a comparable, market-determined price (including costs) to establish normal value. Because China’s claims rest on an erroneous interpretation of the relevant texts, its claims must be rejected.

**a. GATT 1994 Article VI**

124. Article VI:1(a) establishes that dumping occurs when the price of an exported product “is less than the *comparable price, in the ordinary course of trade, for the like product*” in the home market.<sup>252</sup> This suggests that “determining price comparability” under Article VI and the Anti-Dumping Agreement (as referenced in Section 15(a)) refers first to determining whether there *is* such a “comparable price, in the ordinary course of trade.”

125. Understood correctly, Article VI:1 establishes that the dumping comparison requires comparable, market-determined prices or costs. A “comparable price, in the ordinary course of trade” is a market-determined price. Section 15(a)(i) clarifies the view of WTO Members that it is appropriate to use domestic prices or costs in determining price comparability if “market economy conditions prevail” in the industry under investigation. Section 15(a)(ii), the Second

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<sup>251</sup> China’s First Written Submission, para. 156.

<sup>252</sup> GATT 1994, Art. VI:1 (“For the purposes of this Article, a product is to be considered as being introduced into the commerce of an importing country at less than its normal value, if the price of the product exported from one country to another (a) is less than the comparable price, in the ordinary course of trade, for the like product when destined for consumption in the exporting country . . .”).

Note, and GATT accession Working Party reports (as explained below) further confirm that under Article VI it is not appropriate to use domestic prices or costs in determining price comparability if market economy conditions do not prevail. As confirmed by all three texts, “determining price comparability” would lead to rejection of non-market “prices or costs” and not just rejection of “prices.” This is because using “prices or costs” that are determined under market economy conditions is necessary for those values to be comparable prices or costs.

126. Without a “comparable price, in the ordinary course of trade,” or suitable proxy, no dumping comparison can be made. This applies to domestic prices, third-country export prices, and costs of production (which are themselves prices between input suppliers and the producer under investigation).<sup>253</sup> Prices of an industry in which market economy conditions do not prevail are not “comparable” – that is, similar, or of an equivalent quality<sup>254</sup> – to prices that are market-determined.<sup>255</sup> Thus, the use of any third-country export price or costs of production not determined under market-economy conditions cannot generate or serve as a proxy for a comparable domestic price, in the ordinary course of trade – that is, a market-determined price.

127. The subsequent practice of the Contracting Parties supports the interpretation of Article VI:1 (and Article VI:2) as providing the legal authority to ensure comparability and to reject prices and costs not determined under market economy conditions for anti-dumping comparisons. The Contracting Parties, in describing how their domestic legislation defined the Article VI term “normal value,” demonstrated their understanding that normal value could only be established through what were referred to as prices from a “free economy,” prices for goods “freely offered for sale,” prices “in the ordinary course of trade,” and other similar formulations.<sup>256</sup> The Contracting Parties thus held the uniform view that they had the authority to reject non-market prices and costs because they were not comparable – that is, not market-determined.<sup>257</sup> Subsequent practice supports and confirms an understanding of Article VI:1 (and Article VI:2) that domestic prices or costs not determined under market economy conditions may be rejected because these are not “comparable prices, in the ordinary course of trade,” and in

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<sup>253</sup> Normal value may be based on costs determined in accordance with Article VI and the Anti-Dumping Agreement. Where input prices are not market-determined, and thus are not themselves comparable prices in the ordinary course of trade, those prices (costs) would not be suitable to establish a normal value based on those costs. *See, e.g., EU – Biodiesel (Argentina) (AB)*, para. 6.24 (“In addition, in our view, Article 2.2 of the Anti-Dumping Agreement concerns the establishment of the normal value through an appropriate proxy for the price of the like product in the ordinary course of trade in the domestic market of the exporting country when the normal value cannot be determined on the basis of domestic sales. The costs calculated pursuant to Article 2.2.1.1 of the Anti-Dumping Agreement must be capable of generating such a proxy.”).

<sup>254</sup> The dictionary definition of “comparable” is “(of a person or thing) able to be likened to another; similar” or “of equivalent quality; worthy of comparison”. *Oxford American College Dictionary*, (Oxford University Press, 2002), p. 282 (Exhibit USA-26).

<sup>255</sup> For clarity, in this document prices “determined under market economy conditions” and that are “market-determined” are used to refer to prices of an industry or sector in which market economy conditions prevail.

<sup>256</sup> U.S. Third-Party Submission, Attachment 1: Legal Interpretation, paras. 5.5.1-5.5.9.

<sup>257</sup> U.S. Third-Party Submission, Attachment 1: Legal Interpretation, para. 5.9.

accordance with Article 31(3)(b) of the Vienna Convention, it would be appropriate to take the practice described “into account, together with the context,” in interpreting Article VI:1.

128. The practice of Contracting Parties in accessions to the GATT, and the agreements reached in those accessions, also confirms that non-market economy prices and costs may be rejected pursuant to Articles VI:1 and VI:2 of GATT 1994. In the accessions of Poland, Romania, and Hungary to the GATT, the Contracting Parties did not create any exception to Article VI:1 of GATT 1994 in the accession protocol of the acceding non-market economy. Rather, in each case they re-affirmed their ability to reject and replace non-market prices or costs for anti-dumping comparisons.<sup>258</sup> Each of these accessions to the GATT therefore demonstrates the understanding of the Contracting Parties and the acceding party that no new legal authority needed to be provided to permit an importing Contracting Party to reject domestic prices or costs not determined under market economy conditions. Article VI provided the necessary legal authority.

129. Article VI of the GATT 1994 thus clearly establishes that the dumping comparison requires comparable, market-determined prices. Without a “comparable price, in the ordinary course of trade,” no dumping comparison can be made.

The emphasis on transactions in the ordinary course of trade in the definition of dumping makes clear that the GATT presumes the existence of free and open markets where prices are determined by supply and demand under normal competitive conditions. Difficulties therefore arise when dealing with allegations of dumping by state trading countries, i.e. those countries which have centrally-planned economies in which costs, prices and exchange rates are determined without regard to market forces so that none of the usual criteria can be regarded as providing a reliable basis for establishing the normal value of imports from these countries.<sup>259</sup>

130. In sum, Article VI:1, in light of Section 15 of China’s Accession Protocol and Articles 2.1 and 2.2 of the Anti-Dumping Agreement, reflects that, where the economy or an industry or sector of an exporting Member does not generate comparable, market-determined prices and costs (for example, because market economy conditions do not prevail in the Member or an industry or sector), domestic prices or costs are not suitable for an anti-dumping comparison. Instead, an importing Member may find an alternative, market-determined normal value for purposes of making a valid dumping comparison.

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<sup>258</sup> U.S. Third-Party Submission, Attachment 1: Legal Interpretation, paras. 6.2-6.6.2.

<sup>259</sup> J.F. Beseler and A.N. Williams, *ANTI-DUMPING AND ANTI-SUBSIDY LAW: THE EUROPEAN COMMUNITIES* (Sweet & Maxwell, 1986), p. 64 (footnote omitted).

**b. Second Note Ad GATT 1994 Article VI:1**

131. China cites the Second Note Ad GATT 1994 Article VI:1 and an erroneous Appellate Body statement (to be discussed later), but does not engage with the text of the Second Note. Much that has been recently written about the Second Note neglects to consider the history and purpose of this Note, as well as the subsequent practice of GATT Contracting Parties in anti-dumping proceedings involving non-market economy countries. The Second Note is an example of a situation in which comparability is at issue (in the conditions described in that Note). It is a specific expression of the main principle of comparability.

132. The text of the Second Note reads as follows:

*It is recognized that, in the case of imports from a country which has a complete or substantially complete monopoly of its trade and where all domestic prices are fixed by the State, special difficulties may exist in determining price comparability for the purposes of paragraph 1, and in such cases importing contracting parties may find it necessary to take into account the possibility that a strict comparison with domestic prices in such a country may not always be appropriate.*<sup>260</sup>

133. The legal authority to reject “domestic prices” is *not* provided in this text; it is simply “*recognized that ... importing contracting parties may find it necessary to take into account.*”<sup>261</sup> The text of the Note thus reflects that the legal authority for rejecting “domestic prices” exists in “paragraph 1” of Article VI when an importing Member is “determining price comparability” (and in Article VI:2 with respect to the imposition of an anti-dumping measure). The text further identifies just one situation in which special difficulties may arise in determining price comparability; it does not purport to identify all such situations.

134. The negotiating history associated with the Second Note demonstrates that GATT Contracting Parties decided that no amendment to Article VI was necessary to meet “the special problem of finding comparable prices” where home market prices were not market-determined.<sup>262</sup> They agreed instead to “recognize[]” that it would not be “appropriate” to use such non-market-determined prices for purposes of the dumping comparison.<sup>263</sup> The CONTRACTING PARTIES also viewed the authority to reject non-market prices for anti-dumping comparisons as inherent in Article VI:1 (and Article VI:2 with respect to the imposition of anti-dumping measures) as that provision refers to the need to ensure comparability.<sup>264</sup> The Second Note thus is an expression of the general principle that an investigating authority is

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<sup>260</sup> Emphasis added.

<sup>261</sup> U.S. Third-Party Submission, Attachment 1: Legal Interpretation, paras. 4.2-4.7.

<sup>262</sup> U.S. Third-Party Submission, Attachment 1: Legal Interpretation, paras. 4.8-4.8.5.

<sup>263</sup> U.S. Third-Party Submission, Attachment 1: Legal Interpretation, paras. 4.6-4.7.1.

<sup>264</sup> U.S. Third-Party Submission, Attachment 1: Legal Interpretation, section 4.

entitled to ensure comparability, a principle that is firmly rooted in and flows from Article VI of the GATT 1994.

135. The Appellate Body has briefly opined on the meaning of the Second Note in two disputes that did *not* involve findings that required a legal interpretation of the Note. Specifically, in *US – Anti-Dumping and Countervailing Duties*, the Appellate Body said that the Note “provides the legal basis for the use of surrogate values for NMEs in anti-dumping investigations . . . [and] authorizes recourse to exceptional methods for the calculation of normal value in investigations of imports from NMEs.”<sup>265</sup> In *EC – Fasteners*, the Appellate Body said that the Note “allows investigating authorities to disregard domestic prices and costs of such an NME [i.e., a state-controlled NME] in the determination of normal value and to resort to prices and costs in a market economy third country.”<sup>266</sup> However, the Second Note was not the object of a legal interpretation by the panel in either dispute and was not raised on appeal in either dispute.<sup>267</sup> The statements by the Appellate Body are therefore in the nature of *obiter dicta* – statements not necessary to resolve the legal issues raised in the appeal before it<sup>268</sup> – and as demonstrated, the statements are erroneous because they do not read the actual terms of the Second Note.

136. Significantly, in making those statements, the Appellate Body reports do not engage in a reading of the text of the Second Note. There is no consideration given to the fact that, for example, the text:

- confirms that, under GATT 1994 Article VI, an importing Member must “determin[e] price comparability for the purposes of paragraph 1” of Article VI. That is, to make a dumping comparison, the importing Member must find *comparable prices* to establish normal value: “It is recognized that . . . [in the case of a state-controlled economy] special difficulties may exist *in determining price comparability for the purposes of paragraph 1 . . .*”
- identifies *one* situation in which “special difficulties may exist in determining price comparability,” and nothing in the text suggests this is the *exclusive* situation in which “special difficulties may arise or circumscribes the importing Member’s

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<sup>265</sup> *US – Anti-Dumping and Countervailing Duties (China) (AB)*, para. 569.

<sup>266</sup> *EC – Fasteners (China) (AB)*, para. 285. The Appellate Body added in a footnote that the Second Note *Ad Article VI* “on its face” did not appear “applicable to less forms of NMEs that do not fulfil both conditions, that is, the complete or substantially complete monopoly of trade and the fixing of all prices by the State.” *EC – Fasteners (China) (AB)*, n. 460.

<sup>267</sup> *EC – Fasteners (China) (AB)*, para. 291 (indicating that the dispute “concerned the determination of individual and country-wide dumping margins and duties, *not* the possibility of resorting to alternative methodologies in the calculation of normal value in anti-dumping investigations involving China” (emphasis added)).

<sup>268</sup> DSU, art. 17.6 (an appeal of a panel report “shall be limited to issues of law covered in the panel report and legal interpretations developed by the panel”).



investigation “in determining price comparability for the purposes of paragraph 1.”

- uses no language expressing that it is an exception or derogation from Article VI (e.g., “notwithstanding,” “provided that,” “nothing shall prevent”).

137. It is the text of the Second Note, understood according to customary rules of interpretation of public international law,<sup>269</sup> that matters, as findings or recommendations of the “Appellate Body cannot add to or diminish the rights and obligations provided in the covered agreements.”<sup>270</sup> As the Second Note was not the object of legal interpretation by the Appellate Body in either *US – Anti-Dumping and Countervailing Duties* or *EC – Fasteners*, statements in these reports do not support China’s understanding that the Second Note is the only basis or legal authority by which an importing WTO Member may reject domestic prices or costs that are not market-determined for purposes of making an anti-dumping comparison.

138. Finally, Article 2.7 of the Anti-Dumping Agreement provides that Article 2 of the Anti-Dumping Agreement “is without prejudice to the second Supplementary Provision to paragraph 1 of Article VI in Annex I to GATT 1994.”<sup>271</sup> The ordinary meaning of the term “without prejudice” is “without detriment to any existing right or claim; spec. in Law, without damage to one’s own rights or claims.”<sup>272</sup> Article 2.7 should be read then to say:

Article 2 of the Anti-Dumping Agreement is without detriment or damage to the existing right of an importing Member, in the case of imports from a country which has a complete or substantially complete monopoly of its trade and where all domestic prices are fixed by the State, where it is recognized that special difficulties may exist in determining price comparability for purposes of GATT 1994 Article VI:1, to take into account the possibility that a strict comparison with domestic prices in such a country may not always be appropriate.

Article 2.7 thus does not in any way limit the ability of an importing Member, in circumstances where there may be difficulties in determining price comparability other than those described in the Second Note, to account for the possibility that a strict comparison with domestic prices or costs may not always be appropriate. As demonstrated by the U.S. legal interpretation, Article 2.7 recognizes that Article 2 does not change the fundamental concept drawn from Article VI:1 of the GATT 1994 that a dumping comparison requires comparable, market-determined prices to establish normal value.

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<sup>269</sup> DSU Art. 3.2.

<sup>270</sup> DSU, art. 19.2; *see* DSU, art. 3.2.

<sup>271</sup> Anti-Dumping Agreement, Art. 2.7: “This Article is without prejudice to the second Supplementary Provision to paragraph 1 of Article VI in Annex I to GATT 1994.”

<sup>272</sup> *New Shorter Oxford English Dictionary*, 4th ed., L. Brown (ed.) (Clarendon Press, 1993), Vol. I, p. 2333 (Exhibit USA-26); *see* *China - Publications and Audiovisual Products (Panel)*, para. 7.253.

139. The text and negotiating history of the Second Note confirm the reading of Article VI of the GATT 1994, Articles 2.1 and 2.2 of the Anti-Dumping Agreement, and Section 15 of China’s Accession Protocol: An importing Member has the authority under Article VI to reject domestic prices and costs when they are not “comparable prices, in the ordinary course of trade” because they are not determined under market economy conditions.

**c. Article 2 of the Anti-Dumping Agreement**

140. Article 2.1 of the Anti-Dumping Agreement establishes that “a product is to be considered as being dumped, i.e. introduced into the commerce of another country at less than its normal value, if the export price of the product being exported from one country to another is less than the comparable price, in the ordinary course of trade, for the like product when destined for consumption in the exporting country.” This text is nearly identical to Article VI:1; specifically, the second sentence and subparagraph (a). Article 2.1 thus retains the key elements from Article VI:1 for domestic prices or costs to be used to calculate normal value: there must be a “comparable price, in the ordinary course of trade.”<sup>273</sup>

141. China simply ignores the core concept of comparable price, in the ordinary course of trade, and the interpretative material (set out in Attachment 1) that demonstrates a dumping comparison requires comparable, market-determined prices or costs. Article 2.2 of the Anti-Dumping Agreement, when read in light of Article 2.1, therefore does not support China’s position that there are only two alternatives for determining normal value when an investigating authority cannot base normal value on domestic prices or costs. For example, pursuant to Article 2.2, a “comparable” third-country export price must be “representative.”<sup>274</sup> As it is used in Article 2.2, the definition of “appropriate” further suggests that the appropriateness of a third country may be assessed by reference to market principles with the aim of identifying a “comparable price” found in a “suitable” comparison market.<sup>275</sup> Thus for the same reasons domestic market prices may not be used to calculate normal value, a third-country export price may not be considered “comparable” or “representative” if the prices are not market-determined.

142. The text of Articles 2.2, 2.2.1.1, and 2.2.2 also do not support China’s position but rather further reinforce the understanding that, to provide a proper comparison, costs under Article 2.2 also must be determined under market economy conditions. As demonstrated in the attached legal interpretation document, an investigating authority may disregard costs where the prices of inputs are themselves not comparable prices, in the ordinary course of trade.<sup>276</sup>

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<sup>273</sup> U.S. Third-Party Submission, Attachment 1: Legal Interpretation, paras. 7.2-7.4.

<sup>274</sup> U.S. Third-Party Submission, Attachment 1: Legal Interpretation, paras. 7.8-7.8.1.

<sup>275</sup> U.S. Third-Party Submission, Attachment 1: Legal Interpretation, paras. 7.8.1.1-7.8.3.

<sup>276</sup> U.S. Third-Party Submission, Attachment 1: Legal Interpretation, paras. 7.9-7.9.4.

143. The panel and the Appellate Body in *EU – Biodiesel* confirmed this understanding, finding that Article 2.2.1.1 does not limit an investigating authority to examining just the costs reflected in the records of the exporter or producer under investigation.<sup>277</sup> According to the Appellate Body, costs calculated pursuant to Article 2.2.1.1 must generate “an appropriate proxy” for the price of the like product in the ordinary course of trade in the domestic market of the exporting country when the normal value cannot be determined based on domestic sales.<sup>278</sup> The Appellate Body has further correctly differentiated “costs” from “information or evidence” used to establish “costs” by observing “that Article 2.2 of the Anti-Dumping Agreement and Article VI:1(b)(ii) of the GATT 1994 do not contain additional words or qualifying language specifying the type of evidence that must be used, or limiting the sources of information or evidence to only those sources inside the country of origin.”<sup>279</sup> As the Appellate Body recognized, “these provisions do not preclude the possibility that the authority may also need to look for such information from sources outside the country.”<sup>280</sup>

144. In sum, contrary to China’s position, Article 2 of the Anti-Dumping Agreement confirms the principle of price comparability expressed in Article VI:1 of GATT 1994.

Dumping requires a comparison of the price for export with the home-market price to see if the former is lower than the later so that there is a “margin of dumping.” However, what is the “price” in the home market of a nonmarket economy? Almost by definition, given that such an economy is not based on pricing principles, the nominal price of goods may bear little relation to prices that would be set by enterprises in a market/price-oriented economy. . . . Furthermore, the prices may bear little relation to the costs of an enterprise, or “profitability.”<sup>281</sup>

A comparable price is one which will permit a “proper comparison.” Such a comparable price must be market-determined, reflecting commercial practices, independence of buyer and seller, and the interaction of supply and demand. The prices or costs of an industry in which market economy conditions do not prevail cannot be considered comparable prices or costs for purposes of “normal value.”

#### **d. Section 15 of China’s Accession Protocol**

145. Although China’s entire legal argument hinges on the significance of the expiry of Section 15(a)(ii) of its Accession Protocol, China does not claim that the measure at issue is inconsistent with the provisions of Section 15(a) that remain after Section 15(a)(ii) expires.

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<sup>277</sup> U.S. Third-Party Submission, Attachment 1: Legal Interpretation, para. 7.9.3.

<sup>278</sup> *EU – Biodiesel (AB)*, para. 6.24.

<sup>279</sup> *EU – Biodiesel (AB)*, para. 6.70.

<sup>280</sup> *EU – Biodiesel (AB)*, para. 6.70.

<sup>281</sup> J. Jackson, *THE WORLD TRADING SYSTEM*, (2d ed. 1997), p. 335.

China contends that “paragraph 15(a) of China’s Accession Protocol, which *previously* justified the use of a methodology not based on a strict comparison with Chinese home market prices, *ceased* to provide such justification on 11 December 2016,”<sup>282</sup> but China does not put forward any legal analysis of Section 15 in support of this position. It merely assumes that Sections 15(a) and 15(a)(i) expired on December 11, 2016, along with Section 15(a)(ii). But the second sentence of Section 15(d) of China’s Accession Protocol clearly states that only “subparagraph 15(a)(ii) shall expire”<sup>283</sup> and the third sentence clearly shows that subparagraph (a)(ii) is not the only non-market economy provision of Section 15(a).<sup>284</sup>

146. The expiry of Section 15(a)(ii) does not mean that WTO Members no longer have the ability to reject and replace non-market prices or costs for purposes of anti-dumping comparisons. Rather, the legal authority to reject prices or costs not determined under market economy conditions flows from Articles VI:1 and VI:2 of the GATT 1994 and the need to ensure comparability of prices and costs when establishing normal value. As Section 15(a), Section 15(a)(i), and the first and third sentences of 15(d) clarify and confirm, if market economy conditions do *not* prevail in China or in the industry or sector under investigation, then “comparable” prices or costs do not exist for purposes of the dumping comparison.<sup>285</sup> In that situation, an importing Member may use a methodology that is not based on a strict comparison with domestic prices or costs in China.

147. The Appellate Body has, in one report, asserted that Section 15(a) expired by virtue of the second sentence of Section 15(d). It is worth nothing that the Appellate Body report itself recognizes that that statement was *obiter dicta* – a statement not necessary to resolve the legal issue before it – when it stated: “China’s claim before the Panel concerned the determination of individual and country-wide dumping margins and duties, *not* the possibility of resorting to alternative methodologies in the calculation of normal value in anti-dumping investigations involving China.”<sup>286</sup> The Panel thus can find no guidance in the Appellate Body’s erroneous reading of the second sentence of Section 15(d) as it is contrary to the express terms.<sup>287</sup> China’s failure to read the remaining text of Section 15 and the light it sheds on determining price

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<sup>282</sup> China’s First Written Submission, para. 73 (emphasis original).

<sup>283</sup> China Accession Protocol, Sec. 15, para. (d).

<sup>284</sup> U.S. Third-Party Submission, Attachment 1: Legal Interpretation, paras. 8.3.6-8.3.8.

<sup>285</sup> U.S. Third-Party Submission, Attachment 1: Legal Interpretation, paras. 8.2.4-8.2.5.

<sup>286</sup> *EC – Fasteners (China) (AB)*, para. 291 (emphasis added).

<sup>287</sup> The panel report in *US – Shrimp II (Viet Nam)* read the identical expiry language in Viet Nam’s Working Party Report (incorporated into Viet Nam’s Accession Protocol) according to its express terms – that is, it is only subsection (a)(ii) that expires after 15 years, rather than subsection (a). *US – Shrimp II (Viet Nam) (Panel)*, n. 254 (finding that “Paragraph 255(d) [of Viet Nam’s Accession Protocol, which is materially identical to Section 15(d) of China’s Accession Protocol,] indicates, moreover, that ‘the provisions of subparagraph (a)(ii) shall expire on 31 December 2018.’”).

comparability under Article VI of the GATT 1994 and the Anti-Dumping Agreement perhaps can be traced, in part, to its reliance on this statement by the Appellate Body in *EC – Fasteners*.

148. Section 15(a) is not, as China would like the Panel to believe, a “special rule.”<sup>288</sup> Nor is Section 15(a) a derogation<sup>289</sup> from, or exception<sup>290</sup> to, the applicable rules. Rather, as explained below, Section 15(a) confirms and clarifies the well-established legal understanding that in determining price comparability under Article VI of the GATT 1994 and the Anti-Dumping Agreement, domestic prices and costs for non-market economy countries do not, as a rule, constitute a comparable price, in the ordinary course of trade, because they are not determined under market-based conditions.

**i. Sections 15(a)(i) and 15(a)(ii) establish certain rules for determining price comparability, but these rules do not cover all circumstances**

149. Sections 15(a)(i) and 15(a)(ii) set out two circumstances, or “rules,” in determining price comparability. First, Section 15(a)(i) requires an importing Member to “use Chinese prices or costs for the industry under investigation in determining price comparability” when the producers under investigation “can clearly show that market economy conditions prevail in the industry producing the like product.” This “rule” states the expected: comparable prices or costs will normally exist when “market economy conditions prevail” in the industry under investigation, and therefore the industry’s prices or costs must be used. This “rule” confirms that, where market economy conditions do *not* prevail, the industry’s prices or costs will not be “comparable” and therefore need not be used.

150. In contrast, Section 15(a)(ii) states that an importing Member may use a methodology not based on a strict comparison with domestic prices or costs *if the producers cannot clearly show* that market economy conditions prevail in that industry. This “rule” established that an importing Member *need not make any findings* on market economy conditions in an industry to reject domestic market prices or costs, other than the finding that the producers had failed to clearly show that market economy conditions prevail in that industry. This is contrary to the normal situation in which an investigating authority must base its findings on positive evidence.

151. Sections 15(a)(i) and 15(a)(ii) therefore attach a consequence to any evidence brought forward by the industry under investigation. But these two rules do not cover all circumstances, nor do they need to as Article VI of GATT 1994 and the Anti-Dumping Agreement also govern the determination of price comparability.

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<sup>288</sup> See, e.g., China’s First Written Submission, paras. 3, 4, 10, 13, 47, 66, 71, 73, 77, 82.

<sup>289</sup> China’s First Written Submission, para. 66.

<sup>290</sup> China’s First Written Submission, para. 181.

**ii. Section 15(d) sets out three provisions that affect the operation of the “rules” set out in Sections 15(a)(i) and 15(a)(ii)**

152. Perhaps because of its reliance on the erroneous statement in *EC – Fasteners (AB)*, China simply fails to engage with the text of Section 15(d). This is telling as this subparagraph does more than establish a time period within which Section 15(a)(ii) expires – it also sets out situations in which China could today establish that the use of Chinese prices or costs is appropriate. Section 15(d) sets out three provisions that affect the operation of the “rules” set out in Section 15(a)(i) and 15(a)(ii) and confirm that “market economy conditions” are highly relevant in determining price comparability.

153. In the **first sentence** of Section 15(d), if China establishes under a Member’s national law that it is a market economy “the provisions of subparagraph (a) shall be terminated.” This means the “rules” of Section 15(a)(i) and 15(a)(ii), within the framework of Section 15(a), no longer apply. It does not mean that, once China is a market economy under a Member’s national law, that importing Member need not determine price comparability under Article VI of the GATT 1994 and the Anti-Dumping Agreement for purposes of making a dumping comparison.

154. In the **second sentence**, “in any event, the provisions of *subparagraph (a)(ii)* shall expire 15 years after the date of accession.”<sup>291</sup> “In any event” signifies that as of that 15-year mark, China may not have become a “market economy,” the situation contemplated in the first sentence. It is only “the provisions of subparagraph (a)(ii)” that expire. This is different than the first sentence (“provisions of subparagraph (a)”). This difference means that subparagraph (a) and (a)(i) do not expire.

155. The second sentence of Section 15(d), as opposed to the first or third sentences, thus only provides for the expiry of Section 15(a)(ii) as opposed to Section 15(a) as a whole. This difference is critical. Expiry of subparagraph (a)(ii) simply means that the “rule” set out in that provision does not apply beyond 15 years.

156. In the **third sentence**, if China establishes that market economy conditions prevail in an industry or sector, “the non-market economy provisions of subparagraph (a) shall no longer apply to that industry or sector.” The sentence begins with “[i]n addition” – so this is yet another situation affecting the application of the “rules.” The introductory phrase establishes that the subject matter of this sentence is “in addition” to the subject matter of the first and second sentence. This suggests the third sentence remains applicable after the expiry of subparagraph (a)(ii).

157. Under this sentence, it is the non-market economy provisions of subparagraph (a) that no longer apply. This suggests that subparagraph (a)(ii) is not the only non-market economy

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<sup>291</sup> Italics added.

provision of subparagraph (a). Another such provision is subparagraph (a) with its reference to “a methodology that is not based on a strict comparison with domestic prices or costs.”

158. This third sentence gives to *China* the right to seek to demonstrate to an importing Member pursuant to its national law that market economy conditions prevail in an industry or sector. This right of China is significant because it could relieve a producer under investigation of the need to demonstrate that market economy conditions prevail in the industry. If China were successful, the industry or sector would not be subject to the non-market economy provisions of subparagraph (a). This too is expected: because market economy conditions prevail in that industry or sector, comparable prices normally should exist for purposes of making the dumping comparison.

159. Nothing in Section 15(d) implies that at any point in time the basic requirement to ensure comparability, which flows from Articles VI:1 and VI:2 of the GATT, as implemented particularly in Article 2 of the Anti-Dumping Agreement, no longer applies. Section 15(d), **second sentence**, only causes the “rule” in Section 15(a)(ii) – a Member may reject domestic prices or costs in China if the producers cannot clearly show market economy conditions prevail – to expire. As Section 15(a)(i) and the first and third sentences of Section 15(d) make clear, if market economy conditions prevail in China *or* in an industry or sector, then comparable prices or costs could exist because those prices or costs are market-determined. But if market economy conditions do *not* prevail in China or in the industry or sector under investigation, then “comparable” prices or costs may not exist for purposes of the dumping comparison. In that situation, an importing Member may use a methodology that is not based on a strict comparison with domestic prices or costs in China.

**iii. Section 15 is not an exception to the GATT 1994 or the Anti-Dumping Agreement**

160. Section 15 is not an exception to the GATT 1994 or the Anti-Dumping Agreement, but rather a confirmation that in determining price comparability under those agreements, an importing Member may in certain circumstances reject the prices or costs for the product under consideration. It likewise would be incorrect to characterize Section 15 as akin to an affirmative defense, which the responding party must bring forward. Rather, Section 15 clarifies the obligations by which all Members have agreed to be bound. That is, Section 15 provides that Article VI of the GATT 1994 and the Anti-Dumping Agreement continue to apply consistent with the terms of Section 15.

161. The introductory paragraph to Section 15 states that the GATT 1994 and the Anti-Dumping Agreement “shall apply . . . consistent with the following,” referring to the remainder of Section 15. As noted, this text confirms first that these other agreements do “apply” in

determining price comparability for a Chinese industry under investigation. The text reads “consistent with,” which is defined as “compatible or in agreement with something.”<sup>292</sup>

162. For the named agreements to apply “consistent with” Section 15, they should be read as compatible or in agreement with each other. Use of the phrase “consistent with” suggests Section 15 is not to be viewed as an exception or in contradiction to the named agreements, i.e., the text is not “subject to,”<sup>293</sup> “provided that,”<sup>294</sup> “in the event of conflict,” or other similar wording. Section 15(a) deals with “determining price comparability under Article VI of the GATT 1994 and the Anti-Dumping Agreement” using either of two alternative bases for determining normal value, and as the agreements apply consistent with Section 15, the approach for selecting a basis for determining normal value under Section 15 must be considered compatible or in agreement with, not an exception to, the GATT 1994 and Anti-Dumping Agreement.

163. In sum, the provisions of Section 15(a)(i) and Section 15(a)(ii) explain the approach for selecting a basis for determining normal value under two specific circumstances. Both circumstances relate to whether market economy conditions prevail in the industry under investigation. One of those circumstances – rejecting Chinese prices and costs without any additional affirmative finding when the producers under investigation cannot clearly show that market economy conditions prevail in the industry producing the like product – is time-limited. The other is not. Section 15(a) – which is compatible and in agreement with the GATT 1994 and Anti-Dumping Agreement – therefore can be understood as a confirmation that the determination under those agreements of price comparability relates to whether there are comparable, market-determined prices. The expiry of one provision of China’s Accession Protocol – Section 15(a)(ii) – does not mean that WTO Members no longer have the ability to reject and replace non-market prices or costs for purposes of anti-dumping comparisons. That legal authority, i.e., the authority to reject prices or costs not determined under market economy conditions, flows from Articles VI:1 and VI:2 of the GATT 1994.

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<sup>292</sup> *Oxford Dictionary of English*, 3rd ed., A. Stevenson (ed.) (Oxford University Press, 2010), p. 372 (Exhibit USA-26).

<sup>293</sup> Numerous WTO Agreement provisions use the phrase “subject to” to express a limiting condition or exception: Article IV:5 (procedures subject to approval); Article IV:6 (procedures subject to approval); Article VII:1 (budget subject to approval); Article II:1(b), (c) (commitments subject to terms, conditions or qualifications); Article XII:1 (BOP restrictions subject to Article); Article XVIII (BOP restrictions subject to Article); Article XX (general exceptions subject to chapeau); Article XXVIII:4 (authorization to negotiate subject to procedures and conditions); Agriculture Agreement Article 21.1 (GATT 1994 and Multilateral Trade Agreements subject to Agriculture Agreement).

<sup>294</sup> Numerous WTO Agreement provisions also use the term “provided that”: Article IX:3 (waiver authority provided that three fourths of Members agree); GATT 1994 Article II:6(a) (adjustment of tariff concessions provided Members concur); Article III:6 (grandfathering internal quantitative regulations provided that no modifications made to detriment of imports); Article IV(c) (minimum proportion of film screen time provided that proportion does not increase); Article VI:6(c) (permitting special countervailing duty provided that Members immediately informed and may disapprove).



**2. China’s arguments are contradicted by the facts in China and would grant China special rights and privileges under the anti-dumping rules that are not accorded any other WTO Member**

164. China relies on claims of “discriminatory and prejudicial treatment.”<sup>295</sup> China does not argue that prices and costs in China are market-determined. Indeed, China has not made clear how normal value can be determined without reference to a market price, nor has it made clear how the use of prices that do not permit a proper comparison could be justified under Article VI:1 or the Anti-Dumping Agreement. Given the WTO text, practice, and history explained previously, China appears to consider that non-market prices and costs in China alone are comparable to export prices. But this approach would, in China’s view, require “discriminatory and prejudicial” treatment of other WTO Members where market economy conditions do not prevail for the industry producing the imported product. It cannot be that Members are *precluded from inquiring* and taking into account whether or not prices and costs at issue are market-determined, but only for China.

165. China further argues that “WTO Members were permitted to single out China’s products”<sup>296</sup> and that, as a result, Chinese imports get “special treatment.”<sup>297</sup> But Chinese *imports* are not, in fact, treated differently than any other imports. The relevant question concerns Chinese *domestic sales* and whether or not those domestic sales reflect market-determined prices or costs such as would indicate a meaningful normal value. By focusing on the treatment of its products when imported by another Member, China essentially posits that WTO Members should not take into account the *facts in China* that demonstrate an absence of market conditions. China does not explain why it alone should be exempt from the scrutiny of an investigating authority. The obligations of investigating authorities include an unbiased and objective evaluation of the evidence. There is no basis for China’s suggestion that Members should not (or are not permitted to) take into account the facts affecting China’s domestic sales and production – especially when such facts are so well documented and economically meaningful.<sup>298</sup>

166. China claims that for 15 years it was permissible to reject Chinese prices and costs. But China does not acknowledge that it *would not have been (and is not) permissible* to reject Chinese prices and costs *had China* (or its producers) made the case that market-economy conditions in China prevailed in China as a whole or in the sector or industry (absent some other factor affecting price comparability). That China declined to do so during that 15 year period, or afterwards, does not – and cannot – establish that market-economy conditions now therefore prevail in the Chinese economy.

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<sup>295</sup> China’s First Written Submission, para. 2.

<sup>296</sup> China’s First Written Submission, para. 2.

<sup>297</sup> China’s First Written Submission, paras. 5, 7.

<sup>298</sup> *See, supra*, Section III.

167. Alternatively, if China believes that rejection of Chinese prices and costs was justified during that 15 year period regardless of the facts, this *does not mean* that the facts cannot justify rejection of domestic prices and costs *after* that 15 year period. Indeed, China’s emphasis on what it sees as being “singled out” overlooks the exercise of determining price comparability that takes place in *all* dumping comparisons, regardless of origin. If China’s logic were extended, it would suggest that Members are precluded from recognizing and addressing the absence of market prices and costs in *other* countries – not just China. Consider, for example, if an original Member were to transition from a market economy to a non-market economy, such as that in Hungary (in 1973), Romania (in 1971), or Poland (in 1967). Would other Members be precluded in that circumstance from acknowledging the transition as a matter of fact?

168. It may be that China has avoided addressing whether market economy conditions exist in its economy, or in any industry or sector, because it would find considerable difficulty in making a credible case that it has transitioned to a market economy, as foreseen in its accession negotiations. As demonstrated in Section III.C of this submission, the most recent review of the facts on the ground in China does not support the notion that China has transitioned to a market economy. In fact, notwithstanding an aggregate reduction in China’s direct price controls, the remaining controls, especially as applied to factor inputs, influence costs and prices throughout China’s industry-intensive economy. In this light, one can see the attraction for China of a misinterpretation of WTO rules as affirmatively precluding any investigation of whether market economy conditions prevail such that comparable prices or costs, in the ordinary course of trade, can be found. But the law does not support China’s desire to ignore the facts.

169. China “attaches great significance to the agreement that was struck with WTO Members upon [its] accession.”<sup>299</sup> But China must also recognize the significance of the agreement among WTO Members and Contracting Parties to the GATT *prior* to China’s accession. China describes its accession in terms of the “agreement that was struck,”<sup>300</sup> “the bargain,”<sup>301</sup> and that it “paid a price for accession.”<sup>302</sup> China’s description suggests that perhaps China believes it would not have been welcome to join the WTO otherwise. China errs in concluding, however, that by agreeing to China’s accession, Members agreed to depart from the market economy principles underlying the GATT and WTO legal systems. To the contrary, the WTO legal texts, including Section 15 of China’s Accession Protocol, indicate that Members retained the right to reject and replace prices and costs that are not determined under market economy conditions for purposes of making anti-dumping comparisons.

170. All of China’s claims under Article VI:1 of the GATT 1994 and Articles 2.1 and 2.2 of the Anti-Dumping Agreement are predicated on the notion that the only alternatives to using domestic prices are third-country export prices or costs of production. But as the legal

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<sup>299</sup> China’s First Written Submission, para. 1.

<sup>300</sup> China’s First Written Submission, para. 1.

<sup>301</sup> China’s First Written Submission, para. 10.

<sup>302</sup> China’s First Written Submission, para. 2.

interpretation at Attachment 1 and the foregoing argument demonstrates, China has simply ignored and misunderstood the relevant WTO texts. Determining price comparability under Article VI and Article 2 requires comparable, market-determined prices or costs. Where domestic prices or costs are found to be not determined under market economy conditions, those prices and costs may be rejected and replaced with market-determined values. Because China has erred in its understanding of Article VI and Article 2, its claims under those provisions in relation to Article 2(7) of the EU’s Basic Regulation necessarily must fail.

**B. The Measure at Issue Does Not Breach Article I:1 of the GATT 1994**

**1. China has failed to establish its Article I:1 claim because China does not attempt to establish any inconsistency with WTO provisions dealing specifically with anti-dumping**

171. China asserts that Articles 2(1) to 2(7) of the EU’s Basic Regulation are inconsistent with Article I:1 of GATT 1994. According to China, rejecting a Chinese producer’s prices or costs is inconsistent with Article I:1 of the GATT 1994, unless that producer can show market economy conditions prevail with respect to the manufacture and sale of the producer concerned.<sup>303</sup> China argues that the Basic Regulation confers “advantages” on products from “market economy” countries that are not accorded “immediately and unconditionally” to Chinese like products.

172. The Panel will immediately notice that this argument is divorced from any claim that the EU’s Basic Regulation is inconsistent with WTO rules concerning anti-dumping. This is notable and means that China has failed to make out a basis for its Article I claim because it failed to first demonstrate an inconsistency with Article VI or the Anti-Dumping Agreement that provide authority for rejecting non-market prices or costs for purposes of anti-dumping comparisons.

173. Article VI:2 of the GATT 1994 states: “In order to offset or prevent dumping, a contracting party *may levy* on any dumped product an anti-dumping duty not greater in amount than the margin of dumping in respect of such product.”<sup>304</sup> Article 1 of the Anti-Dumping Agreement, which elaborates the application of Article VI, further states: “An anti-dumping measure shall be applied only under the circumstances provided for in Article VI of GATT 1994 and pursuant to investigations initiated and conducted in accordance with the provisions of this Agreement.”<sup>305</sup> In other words, paragraph 2 of Article VI *authorizes* WTO Members to apply anti-dumping duties, and Article 1 clarifies that such anti-dumping measures shall be imposed consistently with Article VI of the GATT 1994 and the Anti-Dumping Agreement.

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<sup>303</sup> China’s First Written Submission, paras. 82-132.

<sup>304</sup> Italics added.

<sup>305</sup> Footnote omitted.

174. An anti-dumping measure that is consistent with Article VI of the GATT 1994 and the Anti-Dumping Agreement is thus authorized by both agreements. In that circumstance, a claim that an anti-dumping measure is inconsistent with Article I of the GATT 1994 must follow a demonstration that the measure is *not authorized* pursuant to Article VI or the Anti-Dumping Agreement. But China’s claim is completely and expressly divorced from any demonstration of an inconsistency with either Article VI or the Anti-Dumping Agreement.<sup>306</sup> In fact, China’s panel request limited its claim under Article I:1 of GATT 1994 in precisely this manner,<sup>307</sup> and China cannot expand the legal basis for its claim at this time.

175. China’s decision to put forward its claim in this manner is an extremely odd choice. China’s submission is a heavily footnoted document; it should not have escaped China’s attention that the nature of an Article I claim has been addressed in prior WTO and GATT disputes. The view in those panel and Appellate Body reports is that Article VI serves to permit anti-dumping measures that might otherwise be inconsistent with certain WTO commitments.<sup>308</sup> Thus, as explained above and reflected in these reports, to demonstrate a breach of Article I, a complaining party must first demonstrate an inconsistency with Article VI or the Anti-Dumping Agreement.

176. China’s failure to make out its claim, and its inability to make out that claim now, is compounded by China’s failure to cite to and establish any inconsistency with the provisions of

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<sup>306</sup> See, e.g., China’s First Written Submission, paras. 85-89, 128-132 (no arguments relating to inconsistency with Article VI or the Anti-dumping Agreement).

<sup>307</sup> China’s Panel Request, WT/DS516/9, paras. 7-8:

7. .... Specifically, following the expiry of paragraph 15(a)(ii), China is concerned that: (i) Articles 2(1) to 2(7) of the Basic Regulation are inconsistent with Article I:1 of the GATT 1994, and (ii) Article 2(7) is inconsistent with Articles 2.1 and 2.2 of the Anti-Dumping Agreement, Article VI:1 of the GATT 1994, and the second paragraph of the Ad Note to Article VI:1 of the GATT 1994 (the “Ad Note”).

8. Articles 2(1) to 2(7) of the Basic Regulation provide for differential treatment of Chinese imports, as compared to imports from other WTO Members. Specifically, in contrast to the treatment afforded imports from other WTO Members, Chinese imports are denied the advantage, favour, privilege or immunity of the rules set forth in Articles 2(1) to 2(6) regarding the determination of normal value, and instead face the less favourable rules set forth in Article 2(7), unless Chinese producers satisfy a requirement in Article 2(7)(b) to demonstrate that so-called “market economy” conditions prevail. As a result, the European Union fails to accord Chinese imports immediately and unconditionally an advantage, favour, privilege or immunity that is granted to like imports from other WTO Members, contrary to Article I:1 of the GATT 1994. This differential treatment ceased to be justifiable when paragraph 15(a)(ii) of China’s Accession Protocol expired on 11 December 2016.

<sup>308</sup> *EC – Fasteners (China) (AB)*, para. 392 (“We observe that Article VI of the GATT 1994 permits the imposition of anti-dumping duties, which may otherwise be inconsistent with other provisions of the GATT 1994, such as Article I:1. Therefore, in our view, a preliminary question to be addressed before determining whether an anti-dumping duty has been imposed inconsistently with Article I:1 of the GATT 1994 is whether the anti-dumping duty had been imposed consistently with Article VI of the GATT 1994.”); *US – 1916 Act (Panel)*, para. 6.220 (“The fact that Article VI provides for a carve-out to Articles I and II . . . merely confirms that duties may be imposed under Article VI without violating Articles I and II of the GATT 1994.”).

Section 15(a) that remain following the expiry of Section 15(a)(ii).<sup>309</sup> This would be necessary to make out a claim under Article I of the GATT 1994 for at least three reasons.

177. First, China’s Accession Protocol is an integral part of the WTO Agreement and deals specifically with anti-dumping comparisons involving imports from China.<sup>310</sup> Second, the introductory clause to Section 15 establishes that Article VI of the GATT 1994 and the Anti-Dumping Agreement “shall apply in proceedings involving imports of Chinese origin into a WTO Member consistent with” Section 15. Section 15 thus relates to the authority to apply anti-dumping measures under Article VI or the Anti-Dumping Agreement. Third, Section 15(a) establishes that in determining price comparability under Article VI 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” rules in that section. Therefore, the remaining text in Section 15 after December 11, 2016, also reflects an authority to reject Chinese prices or costs.

178. It would have been for China to claim and demonstrate an inconsistency with Section 15, as for Article VI and the Anti-Dumping Agreement, to make out a claim that an anti-dumping measure is inconsistent with Article I:1 of the GATT 1994. China’s panel request and first written submission thus lack essential steps in the sequence of the legal analysis that the Panel would need to conduct before it could consider whether the measures at issue are inconsistent with Article I of the GATT 1994.<sup>311</sup>

**2. Even aside from China’s failure to assert the necessary predicate to an Article I:1 breach, China’s claim fails because it has not shown that the measure discriminates between like imported products**

179. As noted, China’s argument that Articles 2(1) to 2(7) of the EU’s Basic Regulation are inconsistent with Article I:1 of the GATT 1994<sup>312</sup> must be rejected because it has framed its claim and its arguments wholly separate from establishing any inconsistency with Article VI of the GATT 1994, Article 2 of the Anti-Dumping Agreement, and Section 15 of China’s

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<sup>309</sup> See China’s Panel Request, WT/DS516/9.

<sup>310</sup> China Accession Protocol, Sec. 1, para. 2 (“This Protocol, which shall include the commitments referred to in paragraph 342 of the Working Party Report, shall be an integral part of the WTO Agreement.”); see *China – Rare Earths (AB)*, paras. 5.18-5.74.

<sup>311</sup> *EC – Fasteners (China) (AB)*, paras. 392-395, 398 (holding that the panel’s finding that the measure at issue is inconsistent with Article I:1 of the GATT 1994 is “moot and of no legal effect” because China’s panel request did not raise a claim under Article VI of the GATT 1994 and thus its finding under Article I:1 “lacks an essential step in the sequence of its legal analysis, that is, the determination of whether and under what circumstances an anti-dumping measure that is inconsistent with the *Anti-Dumping Agreement* may be reviewed under Article I:1 of the GATT 1994 in the absence of a review under Article VI of the GATT 1994.”).

<sup>312</sup> China’s First Written Submission, para. 132.

Accession Protocol. The Panel would therefore not need to consider China’s Article I claims further.

180. But even aside from this flaw, China has not established a basis for its claim under Article I:1. According to China, “the regulatory distinction under Articles 2(1) to 2(7) of the Basic Regulation results in the application of a methodology for determining normal value with respect to Chinese imports that denies an advantage to Chinese imports that is granted to like products from other countries not subject to the same methodology.”<sup>313</sup> The European Union has set out a number of arguments demonstrating that China’s claim is without merit.<sup>314</sup> Importantly, the European Union, when determining normal value for Chinese imports, is not precluded by Article I:1 from rejecting Chinese prices or costs and replacing these with prices or costs determined under market economy conditions. This is because the authority to reject non-market prices or costs exists under Article VI:1 of the GATT 1994, as clarified and confirmed in the Anti-Dumping Agreement, Section 15 of China’s Accession Protocol, and other text. As demonstrated in the preceding section, the Basic Regulation is not inconsistent with these provisions and therefore cannot breach Article I:1.

181. The European Union furthermore does not deny an advantage to Chinese imports that is granted to like products from other countries. As the Appellate Body noted in *EC – Seal Products*, “Article I:1 is concerned, fundamentally, with protecting expectations of equal competitive opportunities for like imported products from all Members.”<sup>315</sup> Article I:1 does not “prohibit[] a Member from attaching *any* conditions to the granting of an ‘advantage’ within the meaning of Article I:1. Instead, it prohibits those conditions that have a detrimental impact on the competitive opportunities for like imported product from *any* Member.”<sup>316</sup> The European Union calculates normal value for all Members exactly “the same,” i.e., based on comparable, market-determined prices or costs.<sup>317</sup> As such, the European Union ensures that all imported products are judged equally on whether the prices or costs of the like products are comparable market-determined prices. Where they are not, those prices or costs may be replaced with market-determined prices or costs.

182. Various provisions of the WTO agreements provide for situations in anti-dumping (and countervailing) duty proceedings where products from one Member may be treated differently from those of another Member, without contravening the obligation in Article I:1 of the GATT

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<sup>313</sup> China’s First Written Submission, para. 112.

<sup>314</sup> See European Union’s First Written Submission, paras. 281-350.

<sup>315</sup> *EC – Seal Products (AB)*, para. 5.88.

<sup>316</sup> *EC – Seal Products (AB)*, para. 5.88 (emphasis original).

<sup>317</sup> European Union’s First Written Submission, paras. 153-156 and Table B.

1994.<sup>318</sup> The proper application of each of those provisions could result in differential treatment that takes the form, for example, of the level of duties, the method of calculating normal value in anti-dumping duty proceedings (or the method of determining the benefit in countervailing duty proceedings). Given the explicit authorization for such actions, it is clear that these actions, where they conform to the requirements of other WTO provisions, are not inconsistent with Article I:1.

183. For China to demonstrate that an advantage is being conferred to other like products that is not conferred on Chinese products, it would need to demonstrate at least that (a) market economy conditions prevail in the industry producing the like product with regard to the manufacture and sale of that product, (b) market economy conditions prevail in another Member's industry for a like product, and (c) the products of the other Member benefit from the use of its prices or costs for establishing normal value while Chinese products do not so benefit.

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<sup>318</sup> For example, Article VI:2 and VI:3 of the GATT 1994 provide for the imposition of anti-dumping and countervailing duties, as a result of which the duties imposed on a product from Member X may differ from those imposed on the like product from Member Y.

The Second Note recognizes that an investigating authority may not be able to rely on a “strict comparison with domestic prices” when determining a dumping margin for products from a Member with “a complete or substantially complete monopoly of its trade and where all domestic prices are fixed by the State.” For products from certain Members but not others, an investigating authority may employ a different methodology for determining normal value even where prices exist in the exporting market.

Article 2.2 of the Anti-Dumping Agreement provides that an investigating authority may resort to constructed normal value, *inter alia*, because of a “particular market situation . . . in the domestic market of the exporting country.” As a result, in an anti-dumping proceeding in which a particular market situation exists, dumping margins for exporters from Member X may be based on costs, whereas those for exporters from Member Y may be based on prices.

Article 14(d) of the SCM Agreement in the context of a countervailing duty proceeding requires that the investigating authority determine, *inter alia*, the government's provision of goods at less than adequate remuneration “in relation to prevailing conditions for the good . . . in the country of provision.” This determination may be made by reference to a benchmark in a market *other than* the country of provision. This may result in the use of an in-country benchmark when assessing the benefit conferred by a financial contribution in Member X, but the use of an external benchmark when making the same assessment with respect to Member Y.

Article 27.10 of the SCM Agreement requires that countervailing duty proceedings on products from developing country Members be terminated if the subsidies or volumes of exports are below a given *de minimis* level.

Section 15(b) of China's Accession Protocol recognizes that an investigating authority may resort to benchmarks outside China where “there are special difficulties in the application” of the guidelines in Article 14(a)-(d) of the SCM Agreement. As in the case of Article 14(d) of the SCM Agreement, this may result in the use of an external benchmark when assessing the benefit conferred by a financial contribution in China, but the use of an in-country benchmark when making the same assessment with respect to another Member.

Even setting aside whether China has shown the “benefit” posited in item (c),<sup>319</sup> China has not attempted to bring forward facts to establish items (a) and (b). Thus, and irrespective of other flaws and errors in China’s arguments, China’s claim under Article I:1 of GATT 1994 must fail for this reason alone.

184. Article 2(7) of the EU’s Basic Regulation does not extend an advantage to like imported products originating in market-economy Members on criteria that have a detrimental impact on the competitive opportunities for like imported products from non-market economy Members. Therefore, although the Panel need not reach China’s Article I:1 claim (and should not, given China’s decision to make that claim in isolation from any claim or argument under Article VI of the GATT 1994, the Anti-Dumping Agreement, and Section 15 of China’s Accession Protocol), were the Panel to consider China’s Article I:1 claim, the Panel should find that the measure at issue is not inconsistent with the European Union’s obligations under Article I:1 of the GATT 1994.

## VI. CONCLUSION

185. The United States appreciates the Panel’s consideration of the legal interpretation set out in Attachment 1 to this submission and of the arguments presented in this submission. Because China has fundamentally misunderstood the relevant WTO texts, there is no basis for its core assertion that prices or costs that are not market-determined may *not* be rejected for purposes of anti-dumping comparisons. To the contrary, WTO Members (and GATT Contracting Parties) have long understood that they had the authority to reject and replace such non-market prices or costs to establish normal value in the context of anti-dumping proceedings. Given that its legal argumentation is fundamentally flawed, China’s claims that the EU’s Basic Regulation is inconsistent with Articles I and VI of the GATT 1994 and Articles 2.1 and 2.2 of the Anti-Dumping Agreement must fail. If China wishes for its producers’ or exporters’ prices or costs to be used in anti-dumping comparisons, it should complete its economic transition and ensure that market economy conditions prevail in its economy.

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<sup>319</sup> For example, there is no support for China’s proposition that determining normal value on the basis of Article 2(7) of the EU’s Basic Regulation leads to higher dumping duties. In 1957, when the GATT Secretariat issued its report on the application of Article VI by Contracting Parties, it was understood that “[p]rices on the home market of State-trading countries may in one instance be higher than the price of the same product would be in a free-trade country a situation which could lead to the levy of anti-dumping duties even in circumstances which economically are not dumping.” *Anti-Dumping and Countervailing Duties: Secretariat Analysis of Legislation, L/712* (Oct. 23, 1957) (Exhibit USA-13). In such a circumstance, the determination of normal value based on domestic prices or costs on the basis of the methodology outlined in Article 2(7) would result in lower dumping margins than the determination of normal value on the basis of domestic non-market prices or costs. Thus there is no truth to China’s assertion that determining normal value on the basis of Article 2(7) necessarily leads to higher dumping duty levels, because it is not true that the prices or costs for like product originating in a non-market economy country will always be lower than the price or costs for like product originating in a free market economy country.