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# CHINESE GOVERNMENT SUBSIDIES

# TO

# THE STAINLESS STEEL INDUSTRY

April 2007

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## APRIL 2007

## I. INTRODUCTION

The stainless steel industry in the People's Republic of China ("China") has undergone explosive growth in recent years, as the Government of China ("GOC") and foreign investors directed massive amounts of capital into the industry.[1] While the Chinese government continues to control through direct and indirect means a significant portion of China's stainless steel industry, joint ventures with foreign partners have become an important part of the industry. As set forth below, the Chinese government has implemented various policies at all levels of government to support the stainless steel industry and its foreign joint venture partners.

Specific information identifying the beneficiaries of subsidies granted by the Chinese government is unavailable due to a lack of publicly available information in China. This report, therefore, makes certain assumptions regarding the availability and use of subsidies to account for the missing public information. For instance, the report assumes that subsidies available to the Chinese steel industry generally are also available to the stainless steel industry in particular.

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[1] Government of China refers to all levels of government, including federal, central, provincial/state, regional, municipal, city, township, village, local, legislative, administrative or judicial levels. This definition is consistent with the Canadian government's approach in the context of Canadian CVD cases against imports from China. See, e.g., Statement of Reasons Concerning the Making of a Final Determination With Respect to the Dumping of Certain Carbon Steel and Stainless Steel Fasteners Originating in or Exported From the People's Republic of China and Chinese Taipei and the Making of a Final Determination With Respect to the Subsidizing of Certain Carbon Steel and Stainless Steel Fasteners Originating in or Exported From the People's Republic of China and Chinese Taipei, Nos. 4214-12, 4218-121, AD/1358, CVD/118, at ¶ 107 (Nov. 3, 2006) (hereinafter "Canada Statement, Nos. 4214-12, 4218-121, AD/1358, CVD/118 (Nov. 3, 2006)").

## II. STRUCTURE OF THE CHINESE STAINLESS STEEL INDUSTRY

Last year, China became the world's largest stainless steel producer when its output exceeded five millions tons for the first time.[2] The 2006 stainless steel output figure represents an increase of more than 60 percent (or three million tons) from production levels in 2005. Id. Stainless steel capacity in China has also been climbing rapidly, with eight million tons of capacity built in 2005 and 2006 alone.[3] By the end of 2006, China had the ability to produce more than 12 million tons of stainless steel during a given period of time.[4]

Although China's consumption of stainless is growing at a rapid rate (approximately 15 percent per year), international trade data trends indicate that China's dependence on imports of stainless steel will end soon, as the country is likely to face an overcapacity situation in coming years. In January through August 2006, for instance, flat rolled stainless exports from China increased by 60 percent to 252,000 tons, while imports fell by 30 percent to 1.4 million tons. Mr. Chen Chuanping, Chairman of the Taiyuan Steel Group, stated recently that the production capacity of stainless steel in China should be controlled by restricting new plant building projects. Mr. Chen believes that, if the growth in China's stainless steel capacity is not controlled, the resulting overcapacity will cause strong side effects in the global marketplace within the next two years.[5]

The Chinese Government has done little to curb the explosive growth in its stainless steel industry. Indeed, as discussed below, China's National Development and Reform Commission

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[2] "World's Largest SS Producer," Stainless Steel World (Jan. 22, 2007) available at http:// http://www.stainless-steel-world.com/news/newsdetail.aspx?newsID=12495.
[3] "SS output to rise in China," Stainless Steel World (Nov. 30, 2006) available at http://www.stainless-steel-world.com/news/newsdetail.aspx?newsID=12299.
[4] "World's Largest SS Producer," Stainless Steel World (Jan. 22, 2007) available at http:// http://www.stainless-steel-world.com/news/newsdetail.aspx?newsID=12495.
[5] "China to face excess SS," Stainless Steel World (Aug. 16, 2006) available at http://www.stainless-steel-world.com/news/newsdetail.aspx?newsID=11722.

approved numerous, significant new projects in 2005 and 2006, with no less than 20 new plants to commence production in 2007.[6] These new plants are certain to further swell China's export volume, which increase by 137 percent in 2006 to 852,000 tons.[7] China's growing stainless steel exports are, moreover, likely to adversely impact the U.S. market, where China became the largest foreign supplier of stainless steel in 2006.[8]

The Chinese stainless steel industry is largely state-owned. The Government of China owns a majority stake in numerous Chinese stainless steel producers, including two of the country's largest stainless steel producers, Shanghai Baosteel Group Corporation ("Baosteel Group") (85.41 percent) and Tangshan Iron and Steel (61.31 percent). These government-owned stainless steel producers have implemented ambitious expansion plans. For instance, Baosteel Group operates various subsidiaries involved in the production of stainless steel products. The primary stainless steel producer in the Group, Baosteel Group Shanghai No.1 Iron & Steel Co., Ltd., significantly increased its stainless steel production capacity in recent years by investing 11.78 billion Yuan (e.g., added stainless steel meltshops in 2003 and 2005 and downstream slab caster in 2005).[9] Similarly, Tangshan Stainless, a subsidiary of Tangshan Iron and Steel, plans to begin stainless production by the end of 2007 when it commissions a 600,000 tons per year hot rolling mill project.[10] "According to officials, a 300,000 tons per year cold rolling project is also scheduled to be launched by the end of 2007. The cold rolling project is owned by Hongwen

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6 "World's Largest SS Producer," Stainless Steel World (Jan. 22, 2007) available at http:// http://www.stainless-steel-world.com/news/newsdetail.aspx?newsID=12495.

7 "China's SS exports up 137%," Stainless Steel World (Feb. 8, 2007) available at http:// http://www.stainless-steel-world.com/news/newsdetail.aspx?newsID=12596.

8 "China Creates SS Tension," Stainless Steel World (Dec. 8 2006) available at http://www.stainless-steel-world.com/news/newsdetail.aspx?newsID=12344.

9 See http://www.baosteel.com/group_e/e12steel_n/index.htm

10 "Tangshan Targets HR Increase," Stainless Steel World (Dec. 6, 2006) available at http://www.stainless-steel-world.com/news/newsdetail.aspx?newsID=12328.

Group, a private company based in Tangshan city, but was constructed by Tangshan Stainless as an auxiliary project for its hot rolling mill." Id.

Additionally, while the Government of China controls a substantial part of China's stainless steel industry, numerous projects have involved significant private and foreign participation. The Chinese government has used subsidies to attract foreign investment, which brings to China capital and modern production technologies. Examples of recent private or foreign projects in the Chinese stainless steel industry include:

- Zhangjiangang Posco Stainless Steel joint venture between Korean stainless flat-rolled producer, Posco (82.5 percent equity interest) and Jiangsu Shangang, as Chinese stainless producer, in Jiangsu province. In August 2006, the joint venture commissioned an integrated stainless steel mill possessing a hot rolled coil plant, with a 800,000 ton per year capacity and 1.4 million ton capacity electric furnace.[11]
- Terra Nostra Resources Corp. opened a 180,000 ton per year capacity stainless steel casting mill in Zibo City, Shandong Province. The facilities include three electric arc furnaces, two AOD furnaces and casting line, which presently produce 100 metric tons of stainless steel billet per day. Construction also remains on schedule for rolling mill production lines, including a 200,000 ton per year capacity strip line.[12]
- Japanese producers Nisshin Steel Corp. (30 percent equity interest), Hanwa Company Ltd. (20 percent equity interest) and Mitsui & Company (20 percent equity interest) and domestic Chinese companies (30 percent equity interest) joined to set up a new stainless steel cold rolled coil center in Shanghai, China.[13]

## III. GOVERNMENT OF CHINA SUPPORT OF THE CHINESE STAINLESS STEEL INDUSTRY

The Chinese steel industry, including the stainless steel industry, benefits from substantial direct aid from the Government of China. Indeed, the Chinese government created the infrastructure for much of the industry and continues to provide substantial support directly

[11] "Posco Open SS Mill in China," Stainless Steel World (Aug. 2, 2006) available at http://www.stainless-steel-world.com/news/newsdetail.aspx?newsID=11657.
[12] "SS Unit Successful," Stainless Steel World (Mar. 9, 2006) available at http://www.stainless-steel-world.com/news/newsdetail.aspx?newsID=4116.
[13] "SS center in Shanghai," Stainless Steel World (Oct. 16, 2006) available at http://www.stainless-steel-world.com/news/newsdetail.aspx?newsID=12051.

to it. The subsidies are provided pursuant to general industrial policies that promote the production of exports and encourage favored industries, such as the stainless steel industry, as well as more specific subsidy programs. The subsidies, moreover, are provided to Chinese stainless steel producers in various forms of government assistance, such as grants and other direct payments to, tax incentives, loans provided on preferential terms, forgiven loans, noncommercial exchanges of unpaid debt for equity shares, the government provision of raw materials and energy at preferential prices, and an undervalued RMB.

**a. China's Steel Policy**

In July 2005, the National Development and Reform Commission ("NDRC") issued China's new Steel and Iron Industry Development Policy ("Steel Policy"), which outlines the government's comprehensive policy for the steel industry. As a whole, the policy provides for the government's management of China's steel industry, including its stainless steel industry, through resource and equipment utilization, regional concentration of output, quality improvements, technological innovation, investment management, and consolidation.

The Steel Policy also mandates direct government subsidization of the Chinese steel and stainless steel industries. For example, Article 16 specifically provides for government support in the form of "tax refunds, discounted interest rates, funds for research and other policy support for major iron and steel projects utilizing newly developed domestic equipment."[14] The policy also calls for indirect support by, among other things, restricting foreign investment, discriminating against foreign equipment and technology, and by providing various export credits. In short, China's Steel Policy is a primary example of the government's attempt to

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[14] See Steel and Iron Industry Development Policy, Order No. 25 of the National Reform and Development Commission, July 2005, ("Steel Policy") at art. 17.

manipulate the steel market and dictate industry outcomes by involving itself in decisions that should be made by the market.

**b. The Five-Year Plans**

China's industrial development, including that of the stainless steel industry, is also directed and managed by the central government through its Five-Year Plans. Issued by the Central Committee of the Communist Party of China, the Five-Year Plans establish the broad parameters defining which industries, enterprises, and products should be targeted for preferential government support. According to the government, Five-Year Plans aim to "arrange national key construction projects, manage the distribution of productive forces and individual sector's contributions to the national economy, map the direction of future development, and set targets."[15] The 10th Five Year Plan for National Economic and Social Development, covering the period 2001-2005, calls for "energetically optimizing and improving [the] industrial sector" by, among other things, enhancing traditional industries with new technologies and intensifying construction of transportation, energy and other infrastructure facilities.[16]

According to the plan, these measures are "most important in the energy [and] metallurgy" industries. Id. The plan further calls for the "establishment of a number of large companies and enterprise groups through stock listing, merging, association and reorganization." Id. It also provides for the continued and pervasive role of the government in the economy, stating that the "state must hold a controlling stake in strategic enterprises that concern the national economy" and must also "uphold the dominance of the public sector of the economy [and] let the state-owned sector play the leading role." Id. China's new 11th Five Year Plan,

[15] See What is the Five Year Plan, available at http://www.china.org.cn/english/MATERIAL/157595.htm.
[16] See The Tenth Five Year Plan for National Economic and Social Development-People's Republic of China, available at http://www.logos-net.net/ilo/195_base/en/init/chn_1.htm.

covering the period 2006-2010, offers more of the same and is designed to "optimize and upgrade industrial structures."[17]

**c. <u>Catalogue of Key Industries, Products and Technologies the Development of Which is Encouraged by the State</u>**

The central government's National Planning Commission periodically issues a "Catalogue of Key Industries, Products and Technologies the Development of Which is Encouraged by the State." This planning document identifies key industries and products which are favored by the central government and therefore eligible for preferential treatment. These favored industries include "stainless steel smelting" and "hot and cold rolling of stainless steel plates."[18]

As a result, stainless steel producers are eligible for various tax exemptions and reductions, including a 50 percent income tax reduction for companies that derive more than 70 percent of their revenues from manufacturing a product listed in the Catalogue. In addition, the Catalogue gives local authorities the discretion to issue policies that help promote the development of the stainless steel industry and its key products.

**d. <u>Catalogue for the Guidance of Foreign Investment Industries</u>**

The government also maintains a "Catalogue for the Guidance of Foreign Investment Industries" which is issued jointly by the NDRC and the Ministry of Commerce ("MOFCOM"). The catalogue distinguishes between encouraged and discouraged industries, with discouraged industries further broken down into those where foreign investment is restricted and those where foreign investment is prohibited. Industries that are discouraged are generally those that are not

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[17] <u>See</u> <u>Key Points of the 11th Five-Year Guidelines</u>, <u>available at</u> http://www.china.org.cn/english/20061h/160403.htm; <u>see</u> <u>also</u> <u>Changes in Five-Year Plans' Economic Focus</u>, <u>available at</u> http://www.china.org.cn/english/2005/Nov/148163.htm.

[18] <u>See</u>, <u>e.g.</u>, <u>Foreign Affairs Information Portal, Current Catalogue of Key Industries, Products and Technologies the Development of Which is Encouraged by the State (Provisional)</u> (Approved by the State Council on Dec. 31, 1997), http://www.bjfao.gov.cn/english/law/003C/144.html.

in line with the central government's national economic development goals. Encouraged industries include the "ferrous metallurgical industry" as well as products, such as "stainless steel smelting" and "hot and cold rolling of stainless steel plates."[19] Investors in encouraged industries are eligible for certain government benefits, including tax reductions and duty waivers.[20]

**e. Grants Provided for Industry Restructuring, Export Performance, and Employing Common Workers**

The Government of China continues to provide a number of direct government grants to the certain Chinese producers. For instance, the Chinese government announced in 2000 that it would spend $6 billion over several years to upgrade and transform its steel industry.[21] The actual amount spent is believed to be much greater.

Additionally, the Government of China confers significant grants upon state-owned enterprises operating at a loss.[22] In reports to the WTO, the Chinese government has identified the following industries as benefiting from these subsidies: metallurgic, ferrous-metal, machinery, coal, oil, chemical, textile, tobacco, and others.[23] Although China promised to eliminate these subsidies in 2000, pursuant to Annex 5B of the Protocol of Accession to the

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[19] See Catalogue for the Guidance of Foreign Investment Industries, Jan. 7, 2003, http://www.chinataiwan.org/web/webportal/W5029562/A5120231.html.

[20] See Revised Catalogue for the Guidance of Foreign Investment Industries, Jan. 2005, http://www.tdctrade.com/alert/cba-e0501a-5.htm.

[21] See U.S. Department. of Commerce, Report to the President, Global Steel Trade: Structural Problems and Future Solutions at 146 (2000). At the time of the announcement, the Chinese Ministry of Commerce stated that the central government – in administering key investment projects – would likely direct local and provincial governments to give the steel industry priority with respect to land use, raw materials, transport, equipment, and water and power supplies. Id.

[22] See World Trade Organization, Transitional Review Mechanism Pursuant to Section 18 of the Protocol of the Accession of the People's Republic of China, No. G/SCM/Q2/CHN/8 (Oct. 6, 2004) (hereinafter " WTO No. G/SCM/Q2/CHN/8 (Oct. 6, 2004)").

[23] Id.

WTO, it has yet to follow through on its commitment.[24] During China's 2002 transitional review, the Chinese representative informed the WTO that these subsidies had been eliminated in 2001. However, subsequent Chinese press reports indicate that the government was working to eliminate these subsidies by 2005 – with still no sign that these subsidies have ceased.

Lastly, the Chinese Government provides grants to promote the production of exports and to support employment. In a countervailing duty case brought against Chinese imports of Chinese carbon and stainless steel fasteners in 2004, Canadian authorities examined grants provided to producers by the Government of China to assist in expanding export sales and to provide employment to common workers. The Canadian government determined that the export-related grants constituted export subsidies contingent upon export performance because the benefits recipient industry was required to satisfy export criteria.[25]

**f. Equity and Debt-to-Equity Investments Made on Noncommercial Terms**

As part of its role in directing the consolidation and restructuring of the steel and stainless steel industries – as set out in China's Steel Policy – the Chinese government has encouraged and even induced various mergers and acquisitions within the steel industry through cash grants and grants of ownership interest. Debt-to-equity swaps are another tool utilized by the Chinese government to prop up state-owned enterprises through direct government infusions of cash. This tool serves essentially as a grant-giving operation. One of China's largest stainless steel producers, Shanghai Baosteel, benefited from this process, as non-performing loans to the company were transferred from state-owned banks to state-owned bank asset management companies ("BAMCs"). The BAMCs then exchanged the debt for shares in the companies. The

[24] Id.
[25] See Canada Statement, Nos. 4243-38, 4218-17, AD/1308, CVD/103 (Dec. 24, 2004). While this case involved stainless steel fasteners, the subsidy programs found by the Government of Canada and cited in this paper are indicative of the types of subsidies granted to manufacturers of other stainless steel products.

OECD reported that these transactions involved "substantial reductions in debt loads in return for restructuring arrangements whose details have not been fully revealed."[26]

Importantly, recent press reports indicate that the government continues to provide the steel industry assistance in the form of cash grants and debt-to-equity swaps. The Asia Times Online reports that China's iron and steel companies have benefited in the amount of 11.19 billion yuan from debt-to-equity swaps as part of the government's plan to restructure and consolidate the steel industry in the years leading up to 2005.[27]

### g. Debt Forgiveness and Inaction Regarding Non-Performing Loans by State-Owned Banks

Another form of direct government assistance to the steel industry is the forgiveness of or inaction regarding non-performing loans by China's state-owned banks. This provides a direct subsidy to the recipients in the amount of the debt forgiven. WTO members have raised concerns regarding China's "automatic roll-over of unpaid principal and interest, forgiven and non-performing loans, and the selective use of below market interest rates."[28] These forms of assistance were cited as direct financial contributions provided by China's state-owned banks to Chinese industry. The Government of China continues to channel financing to preferred industries based on policy considerations instead of market-based factors.

The result is a high level of non-performing loans and repeated bailouts of China's state-owned banks. Loans are generally classified as non-performing when the borrower fails to pay interest and principal according to the original terms of the loan.[29] Standard & Poor's estimates that 40 percent of China's state-owned banks' loans – or roughly $800 billion – are non-

[26] Organization for Economic Cooperation and Development, Reforming China's Enterprises, at 78 (2000).
[27] China's Iron/Steel Industry to See M&A Activity, Asia Times Online, Aug. 24, 2005.
[28] WTO No. G/SCM/Q2/CHN/8, at 3 (Oct. 6, 2004).
[29] See Reform of China's Banks, Burdened by Bad Loans, Is Priority for Government, June 1, 2005, available at http://knowledge.wharton.upenn.edu/index.cfm?fa=printArticle&ID=1202 (hereinafter "Reform of China's Banks, Burdened by Bad Loans, Is Priority for Government").

performing.[30] Other estimates indicate that "borrowers may default on as much as half of [the] loans issued by state banks."[31] The high level of non-performing loans is evidence that state-owned banks continue to loan to enterprises, including steel companies, that are uncreditworthy and that would not meet normal market-based credit terms. The staggering level of non-performing loans has left the state-owned banks virtually insolvent.

As a result, the Chinese Government has been forced to repeatedly inject cash into these banks; in 2003, the government recapitalized the Bank of China and the China Construction Bank with an injection of $45 billion of reserves.[32] To date, the central government is estimated to have spent more than $250 billion since 1998 to bail out the four primary state-owned banks. Standard & Poor's estimates that these banks will require an additional $190 billion in the next several years just to stay afloat.[33] The stainless steel industry is not the only beneficiary of China's lax credit policies. As a favored industry, however, stainless steel producers were likely beneficiaries of massive loans that financed recently-added capacity in China. Without access to the records of the state-owned banks, asset management companies, and other lenders, it is impossible to know the full extent to which the Chinese stainless steel industry has benefited from the Chinese government's willingness to tolerate non-performing loans. Given the industry's growth, however, it is reasonable to conclude that the level of borrowing and benefit to the industry is substantial.

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[30] Id. Statistics released by China's Banking Regulatory Commission indicate that in the first half of 2004, China's major state-owned banks held more than $200 billion in non-performing loans – an undoubtedly conservative estimate given the unreliability of the Commission figures and because the figure likely does not include the billions of dollars of non-performing loans the state-owned banks have sold to state-owned asset management companies. See China Gov't Warns of Possible Rebound in Non-Peforming Loans, Asia Pulse, Sept. 20, 2004. For example, in June 2004, the Bank of China and the China Construction Bank sold nearly 280 billion yuan ($33.7 billion) in non-performing loans to a state-owned asset management company.

[31] Craig Simons, The People's Bank, Newsweek, Dec. 6, 2004, at 37.

[32] See Reform of China's Banks, Burdened by Bad Loans, Is Priority for Government.

[33] Brian Bremmer, The Great Bank Overhaul: Can a Chinese Bank Be A Model for Heroic Reform?, Business Week, Aug. 22, 2005

#### h. **Preferential Loans and Directed Credit from State-Owned Banks**

China's banking system is dominated by the four state-owned banks – the Industrial and Commercial Bank of China, the Bank of China, the China Construction Bank, and the Agricultural Bank of China – which account for over 60 percent of all loans.[34] Traditionally, these banks have made loans based on political directives from the central or provincial governments, rather than creditworthiness or other market-based factors.

These "policy loans" generally have gone to state-owned enterprises and to industries favored by the government, which includes the stainless steel industry.[35] Currently, state-owned enterprises account for 25 percent of China's GDP, but receive over 65 percent of loans from state-owned banks.[36] Moreover, the government has channeled its finances to preferred industries at extremely low, non-market interest rates.[37] These preferential loans, granted on non-commercial terms to inefficient state-owned companies, have subsidized the steel industry and have given the industry an unfair advantage on the market.[38]

Today, both private and state-owned Chinese stainless steel companies continue to have access to subsidized financing from state-owned banks that have a strong incentive to lend to preferred industries such as steel. Indeed, China's Steel Policy specifically provides for export

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[34] Luo Ping, Challenges for China's Banking Sector and Policy Responses (Nov. 14-16, 2003).

[35] See Reform of China's Banks, Burdened by Bad Loans, Is Priority for Government. A recent IMF report concludes that "banks remain exposed to several sectors that are likely over invested, such as steel, cement, aluminum, and construction and, are therefore vulnerable to an economic slowdown and/or consolidation in these sectors." Richard Podpiera, Progress in China's Banking Sector Reform: Has Bank Behavior Changed?, No. WP/06/71, at 11 (Mar. 1, 2006).

[36] See Reform of China's Banks, Burdened by Bad Loans, Is Priority for Government.

[37] According to Morgan Stanley, "prices on a variety of financial instruments" – including interest rates, bank credit lines and bond prices – "are tightly controlled by leadership decisions made at the highest levels of the Chinese government." See Stephen S. Roach, Inside the China Debate, at 2 (Morgan Stanley 2006).

[38] These state-owned banks are, in essence, acting as the government when they provide loans. Indeed, according to the Working Party Report on China's accession to the WTO, "when state-owned enterprises, including banks, provide financial contribution they are doing so as government actors." Thus, to the extent that the loans are being provided on preferential or below market rates, they constitute a subsidy. See WTO No. G/SCM/118 (Nov. 9, 2005) at 12.

credits for steel companies. Article 27 of the policy states: The state encourages and will provide export credit and other support for enterprises engaged in the production of steel and related production equipment to trade or transfer technology by exporting superior domestic technologies and metallurgical equipment sets. Moreover, a WTO report issued in November 2005, summarizing the findings of member countries with respect to China's obligations under its accession agreement, identifies state support to various industries through the banking system, mainly "in the form of policy loans, the automatic roll-over of unpaid principle and interest, forgiven and non-performing loans and the selective use of below-market interest rates." Id.

Member countries concluded that China continues to provide "preferential bank financing to producers of agricultural and industrial goods, despite a clear commitment by China four years ago to eliminate all prohibited subsidies upon its accession to the WTO." Id. at 3. Since 1998, these banks collectively have reportedly benefited from repeated government capital injections and nonperforming loan purchases in excess of $250 billion.[39] The U.S. delegation further stated that:

> [S]tate-owned banks continue to make policy-driven loans that are not commercially justified, and when those loans fail, the loans are written-off and passed to the asset management companies to be dealt with. The recent inauguration of Huida Asset Management Ltd., set up to specifically deal with the non-performing loans of the state-owned People's Bank of China is one such example.

Id. In its 2005 report to the U.S. Congress, the U.S.-China Economic and Security Review Commission determined low and no-cost financing to be "one of the most pervasive forms of subsidies in the Chinese economy."[40] It stated: This system of 'policy lending' whereby capital is allocated for political or strategic reasons using subsidized interest rates and other

[39] WTO No. G/SCM/Q2/CHN/14, at 3 (Sept. 29, 2005).
[40] 2005 Report to Congress of the U.S.-China Economic and Security Review Commission, at 39.

noncommercial terms arguably amounts to a massive government subsidy for Chinese firms that is used both to bolster their operations and to fund acquisitions. Id.

Finally, in the recent stainless steel fasteners case, the Canadian government found actionable subsidies in the form of preferential loans and loan guarantees by the Government of China. Specifically, the Canadian authorities found the existence of preferential interest rates and financing terms provided, either directly by the Government of China or indirectly through financial institutions, to companies satisfying certain export contingent criteria. They also found that loans provided to certain manufacturers, including stainless steel companies, satisfying export-contingent or other criteria are being guaranteed by the Government of China or other state-run financial institutions.[41]

**i. Subsidies to Firms in Special Economic Areas (SEA)**

The Chinese Government provides various financial incentives to manufacturers operating in specified Special Economic Areas ("SEA"), such as Special Economic Zones ("SEZs"), High Technology Industrial Development Zones, Export Processing Zones, free ports, bonded zones, and the like. These SEAs promote investment with unique tax packages and other incentives, many of which benefit the stainless steel industry. The incentives generally include significant reductions or exemptions in national and local income taxes, land use fees, import and export duties, and priority treatment in obtaining basic infrastructure services.[42] The government has also created special incentives for projects involving export-oriented investments and for certain industries, including stainless steel. Id.

[41] Canada Statement, Nos. 4243-38, 4218-17, AD/1308, CVD/103, at 40-41 (Dec. 24, 2004).
[42] See U.S. & Foreign Commercial Service and U.S. Department of State, Doing Business in China: A Country Commercial Guide for U.S. Companies, ch. 6, Investment Climate (2005).

Indeed, Baosteel Group Shanghai Pudong Iron & Steel Co., Ltd., which produces stainless steel, is likely to benefit from subsidies provided pursuant to the SEZ of the Pudong New Area of Shanghai program given its location.[43] Under this program, non-wholly foreign owned FIEs established in SEZs, FEs (wholly foreign owned FIEs) established in SEZs, joint-venture Chinese firms, and single-investor Chinese firms established in the SEZ of the Pudong New Area of Shanghai pay income tax at a reduced rate of 15 percent.[44] The eligibility criteria for this program relating to DIEs located in the Pudong New Area of Shanghai can be found in the *Circular on Income Tax Rate Applied to Chinese Joint Ventures in Pudong New Area of Shanghai*, which specifically identifies Chinese joint venture and single-investor Chinese firms established in the Pudong New Area of Shanghai as being eligible for the reduced income tax rate of 15 percent.

Another example of SEA subsidies is the Jiangsu Yangtze International Metallurgical Industrial Park in Zhangjiagang City, an industrial park composed primarily of steel companies. It advertises the following tax incentives for foreign-funded manufacturing companies: a corporate income tax exemption in the first two profit-making years and a 50 percent reduction in the third-to-fifth profit-making year; local income tax exemptions; a VAT exemption for exported products; exemption of VAT and customs duties on equipment used in the manufacturing process; and a full refund of income taxes paid on profit which is reinvested in export-oriented enterprises.[45]

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[43] See http://www.baosteel.com/group_e/e12steel_n/index.htm.

[44] See Statement of Reasons Concerning the Making of a Final Determination With Respect to the Dumping of Certain Laminate Flooring Originating in or Exported From the People's Republic of China and France and the Making of a Final Determination With Respect to the Subsidizing of Laminate Flooring Originating in or Exported From the People's Republic of China, Nos. 4214-4, 4218-19 at Appendix 3 (Jun. 1, 2005) (hereinafter "Canada Statement, Nos. 4214-4, 4218-19 (Jun. 1, 2005)").

[45] See Investment Guide, Jiangsu Yangtze International Metallurgical Industrial Park.

Additionally, China's subsidies notification identifies preferential tax policies for enterprises recognized as high or new technology enterprises established in the high or new technology industrial development zones. Enterprises located in such areas pay a 15 percent income tax rate and are exempt from income tax for their first two years.[46]

The China Association of Development Zones cites additional tax incentives, including the following:

- Loss compensation schemes whereby any losses experienced by companies in development zones can be offset through reductions in income taxes for a period of 5 years after the loss is incurred. See National Development Zones.
- Regional tax incentives whereby companies in specified regions, including the "Middle Western Areas," are eligible for a 15 percent reduction in income tax after the original exemption-reduction period is over. Id.
- Export-oriented tax incentives whereby taxes are reduced by as much as 50 percent for export-oriented enterprises which export 70 percent or more of their total annual output. Id.

Finally, the Canadian government has identified Special Economic Area incentives as countervailable subsidies. It found that certain incentives were "[a]vailable to [steel] manufacturers operating in regions such as economic and technical development zones, export processing zones, bonded zones and high-technology industrial development zones."[47] It identified the following benefits, either granted outright or contingent on export performance: special land use and investment exemptions, and preferential costs of services and infrastructure provided by government agencies or state-owned enterprises. Id. For instance, the Canadian government found that certain companies located in Special Economic Areas pay reduced long-term land use fees for land on which factories are located. Id.

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[46] China Subsidies Notification at 10.
[47] Canada Statement, Nos. 4243-38, 4218-17, AD/1308, CVD/103, at 40-41 (Dec. 24, 2004).

### j. **The Northeast Revitalization Program**

The Government of China has undertaken an industrial revitalization program which provides "potentially unfair advantages to businesses locating to or operating in Northeast China."[48] Starting in 2003, China's central government has carried out a plan to resuscitate the old industrial base in the three northeastern provinces of Heilongjiang, Jilin, and Liaoning, aiming to build the region into a world-class industrial base.[49] Together, these provinces account for about 10 percent of China's steel production.

Under this program, China is executing a "strategic restructuring and technical transformation of key enterprises in the areas of oil, petrochemical, iron and steel, automotive, shipbuilding and aircraft products manufacturing sectors in Northeast China in a bid to establish production bases of advantage industries."[50] In support of the Northeast Revitalization Program, the central government has offered preferential policies and financial support to industry, including tax incentives and low-interest rate financing.[51] Indeed, in a November 2005 report WTO Member countries concluded that China's state-owned banks continue to extend "subsidized financing for large-scale investment projects in China which were designed to increase the competitiveness of state-owned enterprises, particularly in the Northeast, in industries such as oil and gas, petrochemicals, iron and steel, and ship-building."[52] Furthermore, the WTO cites a report on the MOFCOM website claiming that the Dalian Branch of the Export-Import Bank would provide RMB 5 billion in export credits to companies in northeast China to

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[48] WTO No. G/SCM/Q2/CHN/14, at 2 (Sept. 29, 2005).
[49] China's Old Industrial Base Eyes Bright Future With Ambitious Plan, People's Daily Online, http://english.peopledaily.com.cn/200401/09/print20040109_132185.html
[50] WTO No. G/SCM/Q2/CHN/14, at 2 (Sept. 29, 2005).
[51] See China's Old Industrial Base Eyes Bright Future With Ambitious Plan.
[52] See WTO No. G/SCM/118 (Nov. 9, 2005) at 12.

enter global markets. According to the report, MOFCOM states that, since November 2003, "low-cost credit provided by the bank has saved the enterprises [RMB] 150 million interest." Id.

#### k. Preferential Tax Programs

The central, provincial, and local Chinese governments provide a variety of tax exemptions, reductions, and credits which directly benefit the steel industry. As discussed above, China's general industrial policies mandate tax incentives for specified industries, including stainless steel. Article 16 of China's Steel Policy, for instance, specifically provides for government support in the form of "tax refunds … and other policy support for major iron and steel projects."[53] In addition to the general policies, the Government of China confers tax subsidies under the following programs.

##### i. Tax Benefits to Foreign Invested Enterprises ("FIE")

The Government of China provides various tax subsidies to foreign invested enterprises ("FIE") in China. These subsidies include:

- income tax exemption and income tax reductions pursuant to Decree No. 85
- reduced corporate tax rate for foreign invested enterprises
- income tax refund for FIEs who reinvest in Chinese businesses
- exemption of the business tax on technological transfers for FIEs
- VAT rebate on the purchases of domestic equipment by FIEs
- income tax exemption or reduction for dividends, interests, rentals, franchising fees and other forms of income earned by FIEs

##### ii. Preferential Consumption Tax Rates Applied to Producers in China Constitute Import Substitution Subsidies

China's consumption tax regulations, which first went into effect in 1993 and apply to a range of consumer products (e.g., spirits and alcoholic beverages, tobacco, cosmetics and skin and hair care preparations, jewelry, fireworks, rubber, motorcycles and automobiles), may

[53] See Steel Policy at art. 16.

operate as import substitution subsidies.[54] Specifically, under these regulations, China uses different tax bases to compute consumption taxes for domestic and imported products. The effect of the differing tax bases is that the effective consumption tax rate for imported products is substantially higher than for domestic products. These tax subsidies received by domestic products constitute import substitution subsidies because the receipt of the tax subsidy is contingent upon the use of domestic goods over imported goods.

### iii. Exemption of Customs Duty and VAT on Imported Capital Equipment

Chinese firms that import capital equipment used exclusively to produce export products are eligible to receive a full refund of customs duties and VAT on the imported capital equipment.[55] The exemptions of tariffs and import-linked VAT are set forth in the Circular of the State Council Concerning the Adjustment in the Taxation Policy of Import Equipment, which was established on December 29, 1997, and came into effect on January 1, 1998. This program was established in order to attract foreign advanced technology and equipment and encourage structural improvement and technological advancement in industry. The authorities responsible for administering this program are the Ministry of Finance and the Customs General Administration People's Republic of China in cooperation with local provincial and municipal customs branches.

Under this program, enterprises meeting the eligibility criteria set forth below may apply for exemption from tariffs and VAT on imported equipment and its related technologies, components and parts. The enterprise must receive approval of its application from the

[54] See USTR Report to Congress at 37.

[55] The Government of Canada determined that this program confers countervailable subsidies upon Chinese firms. See Canada Statement, Nos. 4214-4, 4218-19 (Jun. 1, 2005).

appropriate authority, and subsequently that approval documentation is submitted to the local customs officials who verify that the documents presented are adequate and that the imported items are not listed in the catalogues of commodities that are not eligible for tax exemptions. The program is also limited to investments by foreign parties in encouraged industrial areas defined by the "Industrial Catalogues for Foreign Direct Investment" and domestic investors investing in encouraged industrial areas defined by "Catalogues of Current Priorities of Industrial Sectors, Products and Technologies Encouraged by the State."

#### iv. Enterprise Income Tax Reduction for Purchase of Domestically-Made Machinery and Equipment

The Chinese government provides tax subsidies for the purchase of domestically-produced machinery and equipment. Specifically, pursuant to the Notice Concerning Some Issues on the Deduction of the Investment Made by Enterprises with Foreign Investment and Foreign Enterprises in Purchasing Domestic Equipment from Enterprise Income Tax, issued jointly by the Ministry of Finance and the State Administration of Taxation on 14 January 2000, "40 per cent of the investment made in purchasing domestic equipment can be deducted from the increment of enterprise income tax." Tax subsidies conferred under this program are countervailable, since the subsidies are contingent upon the use of domestic over imported goods and, therefore, provided on a de jure specific basis within the meaning of 19 U.S.C. § 1677(5A)(B).

### IV. Government Provision of Goods and Services

#### i. Provision of Land and Equipment by the of Chinese Government

Chinese stainless steel companies continue to benefit from land grants or reduced land costs provided by the government. Specifically, much of the assets that comprise China's state-owned stainless steel producers were originally 100 percent state-owned and were "contributed" to these producers enterprises. Even after the economic reforms of the 1980s and 1990s, the enterprises were never required to pay for these assets. In this way, these stainless steel producers were essentially given China's stainless steel production capacity. This original gift continues to provide huge benefits to certain firms in the Chinese stainless steel industry, as they did not incur the significant capital costs associated with the development of complete stainless steel production facilities.

By law, all land in China remains the property of the state. Without a market for land, it is impossible to determine whether Chinese steel producers are paying market rates for their land. Shanghai Baosteel, one of the largest Chinese producers of stainless steel products, shows deferred expenses of 1.689 million RMB, or about $200,000, for "transfer price for land use rights & site formation fee."[56] The fee for 2004 was 187,724 RMB. Id. If this figure in fact represents the company's long-term cost for land, it would appear to be far below any market value. For the whole industry, below-market rents for land represent a substantial subsidy to the Chinese stainless steel industry each year.

#### ii. Provision of Energy Inputs by State-Owned and State-Invested Enterprises

"China's pricing structure for energy resources and utilities has been criticized for causing artificially-low prices …," and, thereby, subsidizing certain industries.[57] For instance, the Government of China acknowledges in Annex 5A, Section XV to China's Protocol of Accession to the WTO, that it provides subsidies in the form reduced prices on inputs (i.e., coal used for electricity generating and crude oil) consumed by "special industrial sectors."[58]

[56] Shanghai Baosteel, Annual Report 75 (2004).
[57] China to Raise Retail Electricity Prices, Forbes, Mar. 2, 2006.
[58] It is important to note that while the GOC identifies coal and crude oil as subsidized inputs, it is possible that other inputs consumed by "special industrial sectors" are being provided by the government at subsidized prices.

Additionally, the National Development and Reform Council sets prices for both natural gas and electricity. Anecdotal evidence indicates that, for electricity in particular, local authorities, which control local utilities, may charge favored enterprises reduced rates for electricity, if indeed Chinese producers pay for utilities at all. Thus, encouraged industries, such as the Chinese stainless steel industry, benefit from low prices for both electricity and natural gas. Because energy accounts for a substantial portion of the cost of producing stainless steel, this subsidy represents a sizable benefit to Chinese producers.

### iii. Chinese Government Restrictions on Exports of Raw Materials

The Chinese government also indirectly keeps the prices of certain key raw materials, such as scrap, for stainless steel production low by placing restrictions on the exportation of those materials. The best-known case involves coke, which is an essential input into making steel using the traditional blast furnace. In 2004 and 2005, China imposed a quota on exports of coke of 14.3 million metric tons. By contrast, China's coke production in 2004 was 208 million metric tons. This caused the price for coke exported from China to rise to artificially high levels[59] and had a "significant, adverse effect on U.S. integrated steel producers and their customers."[60]

The export restrictions provide a benefit to the Chinese steel industry in two distinct ways. First, as a matter of basic economics, increasing the supply of an input without increasing demand will cause the price of the input to drop. By keeping the domestic supply of the raw material artificially high, the Chinese government keeps its domestic price artificially low. At the same time, the export restrictions make the Chinese material more expensive for foreign steel

[59] World Trade Organization, China's Transitional Review Mechanism: Communication of the United States, No. G/MA/W/71, at 3 (Sept. 6, 2005)
[60] United States Trade Representative, 2004 Report to Congress on China's WTO Compliance 33 (2004).

producers, reducing their competitiveness vis-à-vis the Chinese industry. In late June 2005, for example, Chinese steel producers were paying only $139 per metric ton for coke, while foreign steel producers were paying $220 per metric ton for the same coke.[61] In this way, the Chinese government's control over raw material exports provides the Chinese industry with a double advantage.

The Chinese government has made it clear that it intends to continue to restrict exports of raw materials where this will benefit its domestic industries. Article 30 of the Steel Policy states specifically that "{t}he export of such preliminarily processed products as coke, iron alloy, pig iron, waste steel and steel base (ingot) with high energy consumption and serious pollution shall be restricted … ."[62] Despite complaints from its trading partners, China will continue to impose restrictions on the export of key raw materials to keep domestic prices low.

**b. Currency Misalignment**

It is impossible to overstate the benefit the Chinese government's manipulation of the value of the RMB provides to Chinese stainless steel producers. Although the U.S. government has thus far declined to make a formal finding of manipulation, there can be no doubt that China actively manages the value of the RMB to benefit Chinese exporters, including the stainless steel industry.

The Chinese government has manipulated the value of the RMB to minimize its fluctuation vis-à-vis the U.S. dollar. By comparison, the currencies of other major trading partners of the United States have fluctuated significantly. Between February 2002 and March 2006, for instance, the U.S. dollar fell in value by an average of 15 percent against all currencies. Over that period, the dollar declined by an average of 24 percent against the euro and other

[61] World Steel Dynamics, Steel Thermometer #24, at 15 (June 30, 2005).
[62] Steel Policy, art. 30

industrialized country currencies, but by only about 1.6 percent against the Chinese RMB.[63] This startling difference reflects the impact of currency manipulation by China.

China's vague promises to allow the RMB to float across a wider range have been too small to have a measurable effect on trade. Although China has raised the peg for the yuan and announced plans to value the RMB against a basket of currencies, the RMB has appreciated by only a small amount and still tracks the dollar quite closely.

To keep the RMB's value down, the Chinese government must make enormous purchases of U.S. dollars, usually in the form of U.S. government bonds. The Chinese government's purchases of U.S. dollars and other securities are currently averaging about $200 billion per year. These purchases amount to fully nine percent of China's GDP. Chinese government purchases of dollars and other securities create a significant subsidy of more than 20 percent on China's exports.[64] Thus, China's misalignment of its currency subsidizes the Chinese stainless steel industry and gives Chinese exports of stainless steel a huge advantage in world markets.

## V. CONCLUSION

The Chinese stainless steel industry continues to benefit from massive direct and indirect subsidies. These subsidies are likely to continue unabated, as the Chinese government recently adopted an official policy that requires it to continue subsidizing its metallurgical industry, which includes stainless steel producers. The consequences of these actions have been profound. The growth of the Chinese stainless steel industry to the point of excess capacity has been at the expense of its international competitors. The economic stability of the international stainless

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[63] Federal Reserve Statistical Release, Foreign Exchange Rates, available at http://www.federalreserve.gov/releases/h10/Hist/.

[64] P. Morici, The Doha Round: No Help for America's Trade Deficit? 21 (2006), available at http://www.morici-dohareport.org/NoHelpForAmericasTradeDeficit.pdf.

steel market and the financial viability of U.S. stainless steel producers demand that the Government of China end its policy of subsidization of the Chinese stainless steel industry.


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