

DATE: March 29, 2007

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SUBJECT: Countervailing Duty Investigation of Coated Free Sheet  
Paper from the People's Republic of China - Whether the  
Analytical Elements of the *Georgetown Steel* Opinion are  
Applicable to China's Present-Day Economy.

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**I. BACKGROUND**

On November 20, 2006, the Department of Commerce (the "Department") initiated a Countervailing Duty Investigation ("CVD") investigation on imports of coated free sheet paper

from the People's Republic of China ("China"). This is the first CVD investigation involving China since 1991. The initiation of the present investigation requires that the Department review its long-standing policy of not applying the CVD law to non-market economy ("NME") countries, such as China.

On December 15, 2006, the Department issued a notice requesting comment on the applicability of the CVD law to imports from China. *See Application of the Countervailing Duty Law to Imports From the People's Republic of China: Request for Comment*, 71 FR 75507 (Dec. 15, 2006). In that notice, the Department cited to the 1986 decision of the Court of Appeals for the Federal Circuit, which affirmed the Department's discretion not to apply CVD law to NMEs. *See Georgetown Steel Corp. v. United States*, 801 F.2d 1308 (Fed. Cir. 1986) ("*Georgetown Steel*").

This memorandum focuses on whether the analytical elements of the *Georgetown Steel* opinion, which was framed according to the traditional, Soviet-style economies of the 1980s, are applicable to China's present-day non-market economy. As discussed in detail below, given the substantial difference in the economies at issue in *Georgetown Steel* and China's economy during the period of investigation in the current proceeding, we find that the Department's policy that gave rise to the *Georgetown Steel* litigation is inapposite to the current investigation and does not bar the application of the CVD law to imports from China.

## **II. THE DEPARTMENT RECENTLY REAFFIRMED CHINA'S STATUS AS AN NME**

On December 22, 2005, respondents in the antidumping investigation of *Certain Lined Paper Products from China* submitted a request that the Department initiate a review of China's status as an NME country. On February 2, 2006, the Government of the People's Republic of China ("PRC Government") submitted a letter (dated December 30, 2005) expressing support for this request, accompanied by a general analysis of the factors considered in such a review. On May 15, 2006 and on August 30, 2006, the Department issued memoranda stating that, while China no longer resembles a traditional Soviet-style command economy, it remains an NME for purposes of the U.S. antidumping law.

The Department has treated China as an NME country in all past antidumping duty investigations and administrative reviews. An NME for purposes of the U.S. antidumping law is defined in section 771(18)(A) of the Tariff Act of 1930 (the "Act") as "any country that the administering authority determines does not operate on market principles of cost or pricing structures, so that sales of merchandise in such country do not reflect the fair value of the merchandise." The Department's designation of a country as an NME applies only to certain U.S. trade remedy proceedings. In making an NME country determination under section 771(18)(A) of the Act, section 771(18)(B) requires that the Department examine an economy as a whole, as opposed to individual industries or companies, and take into account:

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

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

In conducting its recent review of China's status as an NME for purposes of the U.S. antidumping law, the Department considered the totality of China's economic reforms, both as executed through changes in law and policy and as evidenced by the practice and behaviors of commercial, financial and political actors. The Department concluded that, while China has enacted significant and sustained economic reforms, the PRC Government has preserved a significant role for the state in the economy. Indeed, the limits the PRC Government has placed on the role of market forces are sufficient to preclude China's designation as a market economy under the U.S. antidumping law.

For example, the PRC Government continues to insulate the currency from market forces and there are still important restrictions on workers' freedom of movement, as well as on bargaining between labor and management. China has attracted an enormous amount of foreign direct investment, but extensively guides and constrains this investment in line with governmental policy objectives. State-owned enterprises ("SOEs") are still a crucial part of the economy and remain many of the largest enterprises in the country. The government's stated policy is to maintain a leading role for SOEs within many important sectors of the economy. The government no longer sustains such SOEs through the traditional means of direct resource allocations or the setting of prices (which are now largely freely set), but instead through a complex web of regulatory restrictions, control over the allocation of land-use rights, and the continued dominance accorded to the state-owned banking sector. Despite ongoing reforms, there is little evidence that China's banks act as genuine commercial entities. After amassing huge volumes of non-performing loans to SOEs, China's banks have been repeatedly bailed out by the government and shielded from both foreign and domestic competition. Despite official pronouncements to the contrary, credit in China still flows primarily to state-owned firms, large enterprises, and enterprises favored by the state for development. Finally, the lack of a reliable set of laws and procedures serves in part to preserve the role of the state in the economy, rather than simply being a feature of a chaotic period of transition.<sup>1</sup>

Although the Act enumerates the six factors that the Department must consider in

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<sup>1</sup> See generally, May 15, 2006 Memorandum, *The People's Republic of China (PRC) Status as a Non-Market Economy* in the lined paper investigation ("May 15 Memorandum") and the August 30, 2006 Memorandum *China's Status as a Non-Market Economy* ("August 30 Memorandum").

determining a country's market economy status for purposes of the U.S. antidumping law, the statute provides no direction or guidance with respect to the relative weight that should be placed on each factor in assessing the overall state of the economy. In the case of China, the Department found in its August 30 memorandum that despite the significant progress that China has made away from being a traditional command economy, the extent of government control and direction over the country's economy warrants the continued designation of China as an NME.

### III. CHINA'S ECONOMY IS SIGNIFICANTLY DIFFERENT FROM THE SOVIET-STYLE ECONOMIES AT ISSUE IN *GEORGETOWN STEEL* .

China's economy presents a significantly different picture than the traditional communist economic system of the early 1980s, *i.e.*, the so-called "Soviet-style economies," such as the economies at issue in *Georgetown Steel*.<sup>2</sup> These economies were characterized by both the Court and the Department as economies with a marked absence of market forces, in which:

"(p)rices are set by central planners. 'Losses' suffered by production and foreign trade enterprises are routinely covered by government transfers. Investment decisions are controlled by the state. Money and credit are allocated by the central planners. The wage bill is set by the government. Access to foreign currency is restricted. Private ownership is limited to consumer goods."<sup>3</sup>

These non-market features were apparent in all of the NMEs at issue in *Georgetown Steel* in 1984, including the Soviet Union and Czechoslovakia, the economies of which were both characterized by "the deliberate and almost complete severance between market forces and allocation and use of resources."<sup>4</sup>

In 1984, virtually every aspect of these economies was governed by extensive mandatory five-years plans created and administered by central planners. Production quotas were set for all SOEs, with near-complete government ownership and operation of all industries, banking, transportation, and communication systems, trade and public services, and most of the agricultural sector. Leaders and planners directed the flow of all materials, directly setting prices for nearly all factors of production, including labor and capital. The central government exercised complete control over investment and consumption in accordance with party priorities,

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<sup>2</sup> Although the *Georgetown Steel* opinion only applied to imports from the Soviet Union and the German Democratic Republic, the Court also relied on the Department's reasoning in the wire rod investigations involving Czechoslovakia and Poland.

<sup>3</sup> See *Georgetown Steel Corp. v. United States*, 801 F.2d at 1315 quoting *Carbon Steel Wire Rod from Poland; Final Negative Countervailing Duty Determination*, 49 Fed. Reg. 19375, 19376 (May 7, 1984).

<sup>4</sup> *Library of Congress Country Studies, Czechoslovakia (hereafter, "Czechoslovakia Study")*, Economic Structure and its Control Mechanisms, August 1987.

the details of which extended down to the level of every enterprise.<sup>5</sup>

As discussed below, these NMEs are significantly different from China's non-market economy of today. China's economy, though riddled with the distortions attendant to the extensive intervention of the PRC Government, is more flexible than these Soviet-style economies.

### *Wages and Prices*

Pricing committees, or similar state agencies, administratively set nearly all prices in the Soviet-style economies of the 1980s. Moreover, prices were not fixed with any deference to the forces of supply and demand, but rather served as an accounting device between supplier and consumer enterprises. In contrast, although price controls and guidance remain on certain "essential" goods and services in China, the PRC Government has eliminated price controls on most products; "market forces now determine the prices of more than 90 percent of products traded in China."<sup>6</sup>

Similarly, in NMEs in the 1980s, party and government officials set wage scales, work norms and labor productivity targets.<sup>7</sup> China's previous cradle-to-grave employment system was modeled on these Soviet-style economies. However, labor regulations in the early 1990s abolished central planning for labor allocation. The current *Labor Law* grants the right to set wages above the government-set minimum wage to all enterprises, including foreign-invested enterprises ("FIEs"), SOEs and domestic private enterprises.<sup>8</sup> Wages between employer and employee appear to be negotiated, as opposed to government-set.<sup>9</sup>

The fact that enterprises generally are free to set wages and the majority of prices does not *ipso facto* lead to the conclusion that wages and prices are market-based in all instances. Private enterprises and citizens in China, though generally free to pursue entrepreneurial activities, still conduct all business within the broader, distorted economic environment over which the PRC Government has not ceded fundamental control. For example, our August 30 memorandum describes a number of important institutional constraints on the extent to which market forces can act upon the formation of wages, including the *hukou* system (*i.e.*, an administrative system governing permanent residence which restricts labor mobility) and the

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<sup>5</sup> *Id.* See also *Library of Congress Country Studies, Soviet Union (hereafter, "Soviet Union Study")*, Economy, May 1989.

<sup>6</sup> *The Economist Intelligence Unit, Country Commerce: China*, 2006, p 73.

<sup>7</sup> *Czechoslovakia Study*, Labor Force, August 1987.

<sup>8</sup> August 30 Memorandum at 15-21.

<sup>9</sup> *Id.*, at 22.

lack of independent trade unions.<sup>10</sup>

### *Access to Foreign Currency*

Access to foreign currency was extremely circumscribed in Soviet-style NMEs. In 1986, the Czech currency was only convertible under very restricted conditions and could not be used in foreign trade.<sup>11</sup> The Soviet *ruble* was completely inconvertible and not permitted to be used in foreign trade.<sup>12</sup> China's currency, on the other hand, is freely convertible on the current account today. Although the convertibility of the *renminbi* on the capital account is limited, the PRC Government has begun to liberalize capital account transactions. Domestic and foreign companies and individuals are free to acquire, hold and sell foreign exchange, and foreign companies are free to repatriate capital and remit profits. It is important to note, however, that China's central bank, the People's Bank of China ("PBOC"), continues to manage the exchange rate, allowing only modest movements in the value of the currency. Therefore, while enterprises and citizens generally have *access* to foreign currency for trade purposes (in contrast with the Soviet-style economies), China's reforms to date do not ensure that the *renminbi* is truly market-based.<sup>13</sup>

### *Personal Property Rights and Private Entrepreneurship*

Personal property rights, an important precursor to private enterprise, were extremely limited in Soviet-style economies. In the USSR in the 1980s, citizens could own personal property and sell this property as "used," but were not permitted to engage in entrepreneurship. Private enterprise was not officially permitted or tolerated in the Soviet Union until 1987, and then only in limited spheres of the economy.<sup>14</sup> Instead, planners in Soviet-style economies controlled all aspects of the state-owned economy, specifying production targets not only for goods, costs, and distribution, but also allocating labor, materials and energy. Production plans were devised all the way down to the level of individual enterprises, and were reflected in output goals and performance indicators that management was expected to meet or exceed.<sup>15</sup>

Starting in the 1990s, the PRC Government began to allow the development of a private industrial sector, which today dominates most of the industries in which the PRC Government

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<sup>10</sup> *Id.*

<sup>11</sup> *Czechoslovakia Study*, Banking and Finance, August 1987.

<sup>12</sup> Holzman, Franklyn, *Moving Toward Ruble Convertibility*, *Comparative Economic Studies*; Fall 1991, at 4 *et al.*

<sup>13</sup> August 30 Memorandum at 13.

<sup>14</sup> *Soviet Union Study*, Economic Structure, May 1989.

<sup>15</sup> *Id.*

has not explicitly preserved a leading role for SOEs.<sup>16</sup> Despite continuing limitations on private property rights, the private sector's limited access to bank credit and a difficult legal environment for business, entrepreneurship is flourishing in China, in stark contrast to the Soviet-style economies in the 1980s. While the PRC Government maintains the stated goal to preserve a leading role for SOEs in the "core industries" of energy, defense, metals, motor vehicles, transport, and telecom, varying degrees of non-state participation is permitted even in these sectors.<sup>17</sup> The result is an economy that features both a certain degree of private initiative as well as significant government intervention, combining market processes with continued state guidance.

### *Foreign Trading Rights*

In the Soviet-style economies, all foreign trade was operated as a state monopoly with central planners deciding on the type and volume of goods to be exported and imported. State-trading enterprises ("STEs") were the only intermediaries between the domestic export producers or import purchasers and the external market. STEs were generally responsible for arranging contracts, securing financing and setting prices, all of which had little connection with domestic production.<sup>18</sup> In China in 1978, less than 20 STEs held an effective monopoly over the import and export of most goods. By 1998, however, the PRC Government had given foreign trading rights to over 200,000 firms. Although China continues to maintain some import price controls through the use of STEs,<sup>19</sup> the PRC Government has dismantled its monopoly over foreign trade and finally extended foreign trading rights to all FIEs in accordance with its WTO accession obligations.<sup>20</sup>

As described above, the central plans of the Soviet-style economies afforded the management of individual enterprises little or no discretion over business decisions. Wages and input prices were set; investment and material goods were centrally allocated; production quotas and sale prices were dictated. In contrast, private enterprises in China today have significant discretion over these business decisions, even if they frequently must bear onerous business

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<sup>16</sup> August 30 Memorandum at 66.

<sup>17</sup> August 30 Memorandum at 67.

<sup>18</sup> *Czechoslovakia Study*, Economic Structure and Its Control Mechanisms, August 1987.

<sup>19</sup> China's WTO Protocol of Accession lists grain, vegetable oil, sugar, tobacco, crude oil and processed oil, chemical fertilizer, and cotton as products subject to import through STEs. Non-state enterprises that have registered and acquired trading rights may import limited quantities of some of these goods, but in 2005, STEs were allocated 90 percent of wheat imports, 70 percent of sugar imports, 60 percent of maize imports, and 100 percent of chemical fertilizer imports.

<sup>20</sup> United States Trade Representative, *2006 National Trade Estimate Report on Foreign Trade Barriers*, March 31, 2006, p. 96 - 97.

administrative burdens in making and executing such decisions.<sup>21</sup>

SOEs have the legal right and obligation to act as independent economic entities under the 1994 *Company Law* (as amended in 2006), including independent import and export decisions on both amounts and price.<sup>22</sup> However, significant non-market forces may also constrain the actions of SOEs. The PRC Government, through the State-owned Asset Supervision and Administration Commission (“SASAC”), retains the authority to decide any matter related to the increase or reduction of capital, issuance of bonds or changes in corporate structure, such as mergers, divisions or liquidation. In addition to this legal right of oversight, continued local and central government involvement in the business decisions of SOEs (for example, through board appointments), as well as social policy concerns, may affect the commercial nature of SOE operations.<sup>23</sup>

### *Allocation of Financial Resources*

Allocation of credit in Soviet-style economies was generally achieved through the Central Bank. For example, in Czechoslovakia in 1985, the State Bank was “the central bank, the government’s financial agent, the country’s commercial bank, an investment bank and clearing agent... [and] [t]he central authorities controlled most investments directly,” as well as set all interest rates.<sup>24</sup> The banking system in the Soviet Union was also completely state-owned and managed, with Gosbank (the central bank of the Soviet Union) serving as both the central bank and the only commercial bank. The Soviet Ministry of Finance established financial plans to control the allocation of all financial resources in accordance with the wishes of the central planners.<sup>25</sup>

The PRC Government no longer allocates most resources in the economy directly through budgetary outlays, as was the case in these traditional Soviet-style command economies. The government abolished the mandatory credit plan in 1997, under which the PBOC had directly allocated credit to specific sectors, often supporting the operations of loss-making SOEs.<sup>26</sup> The credit plan was replaced with non-binding targets, which were to serve as guidance for credit allocation. Banks were afforded legal autonomy from the state in most matters, which

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<sup>21</sup> August 30 Memorandum at 67 - 69.

<sup>22</sup> August 30 Memorandum at 67 - 69. *See also Trade Policy Review, People’s Republic of China*, at 132-133 (Geneva, World Trade Organization, February 28, 2006).

<sup>23</sup> The chairman and vice-chairman of the board are appointed by the SASAC from among the board members. *Id.*, at 129.

<sup>24</sup> *Czechoslovakia Study*, Banking and Finance, August 1987.

<sup>25</sup> *Soviet Union Study*, Financial System, May 1989.

<sup>26</sup> August 30 Memorandum at 51.

allowed them to lend, at least in theory, having regard to commercial considerations.<sup>27</sup>

Instead of directly allocating all financial resources in the economy, the PRC central and local government's primary levers of economic and financial control lie in its use of administrative measures (which allow for *ad hoc* discretionary policy implementation), five-year plans and industrial policies which may serve as guidance for lending and growth, and decentralized (local) control over the banking sector.<sup>28</sup> The near-complete state ownership of the commercial banking sector enables the government to use non-direct measures to guide the allocation of credit. Thus, the misallocation of financial resources has been evidenced by the continued cycle of lending on a non-commercial basis, the accumulation of a large number of non-performing loans, and government bailouts of the banking sector.<sup>29</sup> Despite the many institutional weaknesses of China's state-owned banking sector, credit to wholly private enterprises, though still a small share of the total amount of credit extended in China today, is growing.<sup>30</sup> While the potential for and evidence of state control over lending decisions persists (especially with regard to lending to SOEs, "pillar" industries, and industries targeted for growth), China's banking system is nevertheless more flexible than the Soviet-style banking sectors, where central banks directly allocated all credit in accordance with the wishes of the party and the central planners.

The PRC Government has resisted a definitive break with its command-economy past, a legacy that continued well into the early 1990s when China's economy was much more similar to the Soviet-style economies at issue in *Georgetown Steel*.<sup>31</sup> The current PRC Government has instead opted to shrink the role of the state in some areas while preserving it in others, but never ceding fundamental control over the economy to market forces completely. Nevertheless, China's economy, though distorted, is observably more flexible than the Soviet-style economies. While the traditional command economies at issue in *Georgetown Steel*, such as Czechoslovakia's and the USSR's, were most notably characterized by the absence of market forces, China's economy is best characterized as one in which constrained market mechanisms operate alongside (and sometimes, in spite of) government plans. As stated above, the limits the PRC Government has placed on the role of market forces are not consistent with recognition of China as a market economy under the U.S. antidumping law.

In sum, the nature of Soviet-style economies in the mid 1980s made it impossible for the

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<sup>27</sup> *Id.*

<sup>28</sup> *Id.*, at 76 and 81.

<sup>29</sup> *Id.*, at 81.

<sup>30</sup> *Id.*, at 59.

<sup>31</sup> For example, the Department did not find a basis for finding market-oriented industries in two antidumping proceedings in the early 1990s. See, e.g., *Rescission of Initiation of Countervailing Duty Investigation and Dismissal of Petition: Chrome-Plated Lug Nuts and Wheel Locks From the People's Republic of China* ("PRC"), 57 FR 10459, (March 26, 1992); and *Final Negative Countervailing Duty Determinations: Oscillating and Ceiling Fans From the People's Republic of China*, 57 FR 24018, (June 5, 1992).

Department to apply the CVD law. To determine that a countervailable subsidy had been bestowed, the Department needed to establish that: (a) the NME government had bestowed a “bounty or grant” on a producer; and (b) that the bounty or grant was specific. The Soviet-style economies at that time made it impossible to apply these criteria because they were so integrated as to constitute, in essence, one large entity. In such a situation, subsidies could not be separated out from the amalgam of government directives and controls.

“Bounties or grants” in Soviet-style economies had no meaning because, given the pervasive role of NME governments in the economy in general, and those industries in particular, an alleged subsidy essentially involved one arm of the government giving money to another arm. The Federal Circuit recognized this, explaining that “[e]ven if one were to label these incentives as a ‘subsidy,’ in the loosest sense of the term, the governments of those nonmarket economies would in effect be subsidizing themselves.” *Georgetown Steel*, 801 F.2d at 1316. In light of this, subsidies would have no meaning in such an economy. Similarly, in an economy essentially comprised of a single entity, it made little sense to attempt to analyze the distribution of benefits for the purpose of applying the specificity test.

The current nature of China’s economy does not create these obstacles to applying the statute. As noted above, private industry now dominates many sectors of the Chinese economy, and entrepreneurship is flourishing. Foreign trading rights have been given to over 200,000 firms. Many business entities in present-day China are generally free to direct most aspects of their operations, and to respond to (albeit limited) market forces. The role of central planners is vastly smaller. In the early 90s, the Department established a test for determining whether Chinese exporters could demonstrate the absence of both *de jure* and *de facto* governmental control over their export activities. *Final Determination of Sales at Less Than Fair Value: Sparklers from the People's Republic of China*, 56 FR 20588 (May 6, 1991), as modified in the *Final Determination of Sales at Less Than Fair Value: Silicon Carbide from the People's Republic of China*, 59 FR 22585, 22587 (May 2, 1994) (Silicon Carbide). If they were able to establish this, then the Department would provide them individual margins that are based on their own sales prices to the United States or individual margins that are based on an average pricing behavior of a set of producers who are representative of the industry. The Department has determined in recent years that many more companies’ export activities are independent from the PRC government in comparison with the early- to mid-1990s.

Given these developments, we believe that it is possible to determine whether the PRC Government has bestowed a benefit upon a Chinese producer (*i.e.*, the subsidy can be identified and measured ) and whether any such benefit is specific. Because we are capable of applying the necessary criteria in the CVD law, the Department’s policy that gave rise to the *Georgetown Steel* litigation does not prevent us from concluding that the PRC Government has bestowed a countervailable subsidy upon a Chinese producer.

The features and characteristics of China's present-day economy also suggest that modification of some aspects of the Department's current NME antidumping policy and practice may be warranted, such as the conditions under which the Department might grant an NME respondent market economy treatment.

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Date