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CORRIGENDUM
This document corrects document SWD(2017) 483 final of 19.12.2017.

Reformatting of the Table of Contents.
Addition of the relevant regulation number on page 2.
Linguistic corrections throughout the text.
Addition of missing footnotes in chapters 12, 14 and 15.
Reformatting of footnotes in the document.

The text shall read as follows:

COMMISSION STAFF WORKING DOCUMENT

ON SIGNIFICANT DISTORTIONS IN THE ECONOMY OF THE PEOPLE'S REPUBLIC OF CHINA FOR THE PURPOSES OF TRADE DEFENCE INVESTIGATIONS

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1. INTRODUCTION

This report has been prepared by the Commission Services for the purposes of point (c) of Article 2 (6a) of Regulation (EU) 2016/1036 of the European Parliament and the Council of 8 June on protection against dumped imports from countries not members of the European Union, as amended by Regulation 2017/2321 ('Basic Regulation' or 'Regulation').

Point (c) stipulates:

> *(c)* Where the Commission has well-founded indications of the possible existence of significant distortions as referred to in point (b) in a certain country or a certain sector in that country, and where appropriate for the effective application of this Regulation, the Commission shall produce, make public and regularly update a report describing the market circumstances referred to in point (b) in that country or sector. Such reports and the evidence on which they are based shall be placed on the file of any investigation relating to that country or sector. Interested parties shall have ample opportunity to rebut, supplement, comment or rely on the report and the evidence on which it is based in each investigation in which such report or evidence is used. In assessing the existence of significant distortions, the Commission shall take into account all the relevant evidence that is on the investigation file.

The Basic Regulation defines in relevant part, i.e. point (b) of Article 2(6a), significant distortions as follows:

> *(b) Significant distortions are those distortions which occur when reported prices or costs, including the costs of raw materials and energy, are not the result of free market forces because they are affected by substantial government intervention. In assessing the existence of significant distortions regard shall be had, inter alia, to the potential impact of one or more of the following elements:*
>
> *- the market in question being served to a significant extent by enterprises which operate under the ownership, control or policy supervision or guidance of the authorities of the exporting country;*
>
> *- State presence in firms allowing the State to interfere with respect to prices or costs;*
>
> *- public policies or measures discriminating in favour of domestic suppliers or otherwise influencing free market forces;*
>
> *- the lack, discriminatory application or inadequate enforcement of bankruptcy, corporate or property laws;*
>
> *- wage costs being distorted;*
>
> *- access to finance granted by institutions which implement public policy objectives or otherwise not acting independently of the State.*

This report examines the existence of significant distortions in the People's Republic of China ('PRC') that are relevant under the Basic Regulation. It comprehensively approaches this topic from three different angles.

First, it examines the core features that give the Chinese economy its current shape and structure (Chapters 2 to 8). These include the very concept of a 'socialist market economy' as embodied in the Constitution of the People's Republic of China ('Constitution')[1] and other laws, the role of the Chinese Communist Party ('CCP', or 'Party') in relation to the economy, the extensive system of plans issued and followed up by various levels of government under the leadership of the CCP, the extensive State-owned sector with its numerous State-owned enterprises including the various supervision and control mechanisms, the financial market, the procurement market and the system of investment screening. All these topics are closely interlinked.

The overall picture that emerges concerning the framework in which economic activity takes place in China is one where the State continues to exert a decisive influence on the allocation of resources and on their prices.

The second part (Chapters 9 to 13) covers the various factors of production. It looks in detail into the provision of land, energy, capital, material inputs (e.g. raw materials) and labour in China. The approach here is horizontal. In other words, the focus is on the situation in general in China with regard to the factors of production.

The analysis shows that the allocation and pricing of the various factors of production is influenced by the State in a very significant manner.

The third part (Chapters 14 to 17) examines a number of sectors. These include steel, aluminium, chemicals and ceramics. The sectors have been selected because they are the ones that have featured most in the EU's anti-dumping investigations since the conclusion of the Uruguay Round. Taking the perspective of individual sectors allows a closer look at the specific rules and dynamics in that sector, but this examination also echoes the findings in the preceding two parts, i.e. the significant distortions resulting from the specific features of the Chinese economy and those found in relation to the various factors of production.

[1] Constitution of the People's Republic of China (Adopted at the Fifth Session of the Fifth National People's Congress and promulgated for implementation by the Announcement of the National People's Congress on 4 December 1982; amended in accordance with the Amendments to the Constitution of the People's Republic of China adopted respectively at the First Session of the Seventh National People's Congress on 12 April 1988, the First Session of the Eighth National People's Congress on 29 March 1993, the Second Session of the Ninth National People's Congress on 15 March 1999 and the Second Session of the Tenth National People's Congress on 14 March 2004): http://www.npc.gov.cn/englishnpc/Constitution/2007-11/15/content_1372963.htm

PART I

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2.1. LEGAL FRAMEWORK

Since 1992, the Chinese State officially practices a socialist market economy.

The framework for the socialist market economy is laid down in various provisions in the Constitution, as well as in the General Program of the Constitution of the CCP.[2] These are then further echoed in essential laws, plans and regulations that define and guide the status of the economic actors in China's market.

[2] Full text of the Constitution of the Communist Party of China, with amendments adopted during the 19th Party Congress: http://news.xinhuanet.com/english/special/2017-11/03/c_136725945.htm (accessed on 07 December 2017).

2.1.1. CONSTITUTION OF THE PEOPLE'S REPUBLIC OF CHINA

Four constitutions have been enacted since the People's Republic of China was founded, each reflecting the changing political objectives of the CCP.[3] The current Constitution[4] was promulgated in 1982, and has since then been amended on a number of occasions. The concept of 'socialist market economy' was first introduced in the 1993 revision. The following provisions in the current version of the Constitution are the most relevant in providing the basis for the socialist market economy:

> Preamble, seventh paragraph:
>
> *China will be in the primary stage of socialism for a long time to come. The basic task of the nation is to concentrate its effort on socialist modernization along the road of Chinese-style socialism. Under the leadership of the CCP and the guidance of Marxism-Leninism, Mao Zedong Thought, Deng Xiaoping Theory and the important thought of Three Represents, the Chinese people of all nationalities will continue to adhere to the people's democratic dictatorship and the socialist road, persevere in reform and opening to the outside world, steadily improve socialist institutions, develop the socialist market economy […] to turn China into a socialist country that is prosperous, powerful, democratic and culturally advanced.*

The preamble sets out key political principles and outlines two key elements in relation to the economy:

- It establishes that China will be in the primary stage of socialism for a long time to come.
- It reaffirms the CCP's leading role with regard to China's overall development, as well as for the development of the socialist market economy (for a more detailed analysis of the CCP's role, see Chapter 3).

The importance of establishing that China is in the primary stage of socialism and will remain so for a long time to come becomes apparent when reading the seventh paragraph of the preamble together with the second paragraph of Article 6:

> *Article 6*
>
> *The basis of the socialist economic system of the People's Republic of China is socialist public ownership of the means of production, namely, ownership by the whole people and collective ownership by the working people. […]*

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[3] Heilmann, S., Rudolf, M. (2017). *The constitution of the party-state*, in Heilmann, S. (Ed.) (2017). *China's Political System.* Lanham, Maryland: Rowman & Littlefield, p. 57.
[4] Constitution of the People's Republic of China (full text after amendment on March 14, 2004). http://www.npc.gov.cn/englishnpc/Constitution/node_2825.htm (accessed 5 May 2017).

In the primary stage of socialism, the State upholds the basic economic system in which the public ownership is dominant and diverse forms of ownership develop side by side and keeps to the distribution system in which distribution according to work is dominant and diverse modes of distribution coexist.

Article 6 confirms that '*socialist public ownership*' remains the basis of China's socialist economic system. Furthermore, it affirms that the State is to uphold the basic economic system in which '*public ownership is dominant and diverse forms of ownership develop side by side*' for as long as China remains in the primary stage of socialism.

The revision of Article 15 of the Constitution introduced in 1993 is particularly telling. Currently, this provision reads as follows:

Article 15

The State practises socialist market economy.

The State strengthens economic legislation, improves macro-regulation and control.

The State prohibits in accordance with law any organization or individual from disturbing the socio-economic order.

Prior to that change, the first sentence ('*The State practises socialist market economy*') read: '*The state practices planned economy on the basis of socialist public ownership'*. In other words, the State acknowledged that China's economy would no longer be fully planned.

Articles 7 and 11 of the Constitution elaborate further the concept of a socialist market economy.

Article 7

The State-owned economy, namely, the socialist economy under 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.

Article 11

The non-public sectors of the economy such as the individual and private sectors of the economy, operating within the limits prescribed by law, constitute an important component of the socialist market economy.

The State protects the lawful rights and interests of the non-public sectors of the economy such as the individual and private sectors of the economy. The State encourages, supports and guides the development of the non-public sectors of the economy and, in accordance with law, exercises supervision and control over the non-public sectors of the economy.

Article 7 reaffirms the State-owned economy as the leading force in China's economy (see Chapter 5.1). However, recognition of the role of the non-public sectors of the economy was first introduced in the 1999 constitutional revision, through the amendment of Article 11. Article 11 – which was then further amended in 2004 - recognises the importance of the non-public sectors of the economy, and declares that the State shall protect the lawful rights and interests of the non-public sectors of the economy, as well as encourage and support them.

Nevertheless, there are no courts which are capable of taking action to secure constitutionally guaranteed rights.[5] Furthermore, the Constitution assigns to the State an interventionist role that goes beyond protecting the rights and interests of the non-public sectors, in that the State shall '*encourage, support and guide*' (emphasis added) their development. Thus, the legal value of such rights is limited.

In short, the Constitution makes it clear that China practices a socialist market economy, that the State-owned economy is the leading force of the economy, and that when it comes to the private economy, the State does not limit itself to encouraging and supporting it, but also guides it. The Chinese State makes use of a variety of different instruments – both incentivising and restricting - to guide the economy. These topics will be further developed in subsequent chapters.

2.1.2. CONSTITUTION OF THE COMMUNIST PARTY OF CHINA

The General Program of the CCP Constitution[6] (revised most recently at the 19th Party Congress on October 24, 2017) reaffirms the socialist market economy as China's economic system and the CCP's active role.

> *The Party must carry out fundamental reform of the economic structure that hampers the development of the productive forces, and keep to and improve the socialist market economy; […]*
>
> *The CCP shall lead the people in developing the socialist market economy. It shall be firm in consolidating and developing the public sector of the economy and shall remain steadfast in encouraging, supporting, and guiding the development of the non-public sector. It shall give play to the decisive role of market forces in resource allocation and ensure the government plays its role better, and establish a sound system for macroeconomic regulation. The Party shall work to balance urban and rural development, development among regions, economic and social development, relations between humankind and nature, and domestic development and openness to the world. It shall adjust the economic structure, transform the growth model, and advance supply-side structural*

[5] See Section 3.4.4.
[6] Full text of Constitution of the CCP, available at: http://news.xinhuanet.com/english/download/Constitution_of_the_Communist_Party_of_China.pdf (accessed on 24 November 2017).

> *reform. The Party shall promote the synchronized development of new industrialization, information technology application, urbanization, and agricultural modernization, and shall build a new socialist countryside, take a new path of industrialization with Chinese characteristics, and build China into a country of innovation and a global leader in science and technology.*

As such, the CCP is to lead the people in developing the socialist market economy, both with regard to the public sector – which the CCP is to unwaveringly consolidate and develop – and the non-public sector – whose development the CCP is to unswervingly encourage, support and guide. The General Program of the CCP Constitution closely mirrors the relevant provisions of the Constitution, making the roles of the State and Party practically indistinguishable.

While the role of the CCP in the Chinese system will be covered in greater detail in Chapter 3, it should be noted that all key policy initiatives stem from the CCP. In the case of the 13th Five Year Plan ('FYP') (see more in Chapter 4.2.7), the role of the CCP is explicitly reconfirmed in the introductory paragraph:

> *Formulated on the basis of the Recommendations of the Central Committee of the Communist Party of China ('CPC') for the 13th Five-Year Plan for Economic and Social Development of the People's Republic of China (2016–2020), the 13th Five-Year Plan sets forth China's strategic intentions and defines its major objectives, tasks, and measures for economic and social development. This plan is to serve as a guide to action for market entities, an important basis for government in performing its duties, and a common vision to be shared among the people of China.*[7]

2.1.3. LAWS, PLANS AND REGULATIONS

Key legislation mirrors the language of the Constitution on socialist market economy, sometimes referring directly to it.

2.1.3.1. COMPANY LAW OF THE PEOPLE'S REPUBLIC OF CHINA

Company Law of the People's Republic of China (revised in 2013),[8] provides in Article 1:

> *The Company Law of the People's Republic of China* […] *has been enacted in order to standardize the organization and activities of companies, protect the lawful rights and interests of companies, shareholders and creditors, safeguard the social and economic order and promote the development of the socialist market economy.*

[7] The 13th Five-Year Plan for Economic and Social Development of the People's Republic of China (2016-2020), http://en.ndrc.gov.cn/newsrelease/201612/P020161207645765233498.pdf (accessed 15 May 2017).
[8] Company Law of the People's Republic of China (adopted by NPC on December 29, 1993, amended in 1999, 2004, 2005 and 2013).

2.1.3.2. PROPERTY LAW OF THE PEOPLE'S REPUBLIC OF CHINA

Property Law of the People's Republic of China,[9] reads:

> *Article 1*
>
> *For the purpose of safeguarding the basic economic system of the state, maintaining the socialist market economic order, clarifying property ownerships, giving play to the utilities of properties and protecting the real right of the right holders, this Law has been formulated in accordance with the Constitution.*
>
> *Article 3*
>
> *In 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 ownerships may develop side by side. The state consolidates and develops the public (state) economy, and encourages, supports and guides the development of the non-public economy. The state practices the socialist market economy system and safeguards the equal legal status and development rights of all market operators.*

2.1.3.3. LAW OF THE PEOPLE'S REPUBLIC OF CHINA ON STATE-OWNED ASSETS IN ENTERPRISES

Law of the People's Republic of China on State-Owned Assets in Enterprises[10] provides that:

> *Article 1*
>
> *This Law is enacted for the purpose of safeguarding the basic economic system of China, consolidating and expanding the State-owned economic sector, strengthening protection of State-owned assets, giving play to the leading role of the State-owned economic sector in the national economy, and promoting the development of the socialist market economy.*

The leading role in the economy assigned to the state-owned sector is further elaborated in the remainder of that law as well as in a series of other legal instruments, for instance the SASAC Regulation and various Guiding Opinions. Moreover, this legal framework also sets out the tight grip of the State and the CCP over SOEs (see in detail in Chapter 5).

2.1.3.4. 13TH FIVE YEAR PLAN

The development of the socialist market economy is also explicitly referred to at two instances in the 13th FYP, in Part I, which contains the overarching principles and objectives

[9] Property Law of the People's Republic of China (adopted by NPC on March 16, 2007).
[10] Law of the People's Republic of China on State-Owned Assets in Enterprises (adopted by NPC on October 28, 2008).

of the 13th FYP, but also in Part XVIII, which covers '*Socialist Democracy and the Rule of Law*'.

> *Part I, Chapter 1: The Development Environment*
>
> *We will follow the principles of socialist political economy with Chinese characteristics, release and develop productive forces, continue in the direction of reform to develop the socialist market economy, […]*
>
> *Part XVIII, Chapter 75, Build a Rule of Law China; Section 1, The Constitution-Centred Socialist Legal System of China*
>
> *We will safeguard the sanctity and authority of the Constitution and improve our systems for enforcing the Constitution and providing oversight over its enforcement. In improving the legislative system, we will strengthen the Party's leadership over legislative work, improve the systems and mechanisms under which legislative work is led by people's congresses that have legislative power,* […]*.We will work faster to see that a complete system of laws and regulations takes shape by speeding up legislation in key areas, working at once to enact, revise, abolish, and interpret laws, and improving laws for the socialist market economy and social governance.* (emphasis added)

In the same paragraph, the 13th FYP aims at strengthening the role of the CCP over China's legislative work, and improving the laws for the socialist market economy.

More details regarding China's system of plans can be found in Chapter 4.

2.1.4. THIRD PLENUM DECISION

In November 2013, at the Third Plenum of the 18th Party Congress, the Chinese leadership announced that it would undertake a comprehensive reform programme.

In the Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform ('the 3rd Plenum Decision'), leaders stated that '*economic system reform is the focus of deepening the reform comprehensively*' and that '*the underlying issue is how to strike a balance between the role of the government and that of the market, and let the market play the decisive role in allocating resources and let the government play its functions better*'.[11]

The 3rd Plenum Decision contained 60 reform proposals, affecting almost all parts of the Chinese economy. It included proposals for the deepening of the reform of the administrative

[11] See Decision of the Central Committee of the CCP on Some Major Issues Concerning Comprehensively Deepening the Reform (adopted at the Third Plenary Session of the 18th Central Committee of the Communist Party of China on 12 November 2013), available at http://www.china.org.cn/china/third_plenary_session/2014-01/16/content_31212602.htm (accessed on 16 August 2017).

examination and approval system, calling for the elimination of examination and approval in areas where the market can effectively regulate itself.

On the other hand, the 3rd Plenum Decision reaffirms that '*the basic economic system with public ownership playing a dominant role and different economic sectors developing side by side is an important pillar of the socialist system with Chinese characteristics and is the foundation of the socialist market economy*'. While this apparent contradiction can be interpreted in a number of ways, it would appear to reconfirm that despite the promises of market-oriented reforms, the basis – a dominant role of state ownership – would remain the same.

To date, implementation of the market-oriented reforms has been assessed by many analysts as inconsistent and selective. The focus has been mainly on rebalancing the Chinese economy into new sectors and technologies rather than to rebalance the role of the State and the market.[12]

2.1.5. THE 19TH PARTY CONGRESS

One of the main outcomes of the 19th Party Congress in October 2017 was the strengthening of the role of the Party's leadership. President Xi Jinping's work report, subsequent speeches during the 19th Party Congress, as well as the general programme of the amended CCP Constitution, reaffirmed the leadership of the Party over 'all work'. According to President Xi Jinping's work report: '*The Party exercises overall leadership over all areas of endeavour in every part of the country.'*[13] This statement was further introduced into the General Programme of the amended CCP Constitution.

The work report reaffirms the role of the State in shaping both the public and non-public sector:

> *We must uphold and improve China's basic socialist economic system and socialist distribution system. There must be no irresolution about working to consolidate and develop the public sector; and there must be no irresolution about working to encourage, support, and guide the development of the non-public sector.*[14]

The speech furthermore proclaims the goal to '*turn Chinese enterprises into world-class, globally competitive firms*', which should be achieved by the means of State support and consolidation: *'[w]e will work to see that state assets maintain and increase their value; we*

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[12] See for example the European Chamber of Commerce in China, (2017). *European Business in China, Position Paper 2017/2018* and the Asia Society/Rhodium Group, (2017). *China Dashboard*, Quarterly Net Assessment, http://chinadashboard.asiasociety.org/china-dashboard/. (accessed on 6 December 2017).
[13] See President Xi Jinping's speech, *Secure a Decisive Victory in Building a Moderately Prosperous Society in All Respects and Strive for the Great Success of Socialism with Chinese Characteristics for a New Era*, Delivered at the 19th National Congress of the CCP October 18, 2017, p. 17.
[14] Ibid., p. 18.

will support state capital in becoming stronger, doing better, and growing bigger […].'[15] The role of the plans is also confirmed: '*[w]e will develop new methods to improve macro-regulation, give full play to the strategic guidance of national development plans*.'[16]

Furthermore, the CCP Constitution was amended to include President's Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era, as it further reaffirms the role of the CCP: '*Leadership of the Communist Party of China is the most essential attribute of socialism with Chinese characteristics, and the greatest strength of this system.*'[17]

The Party Congress follows a period in which the role of the Party in all areas of the State has strengthened and become far more visible, and reconfirms these developments. The signals received at the 19th Party Congress are that China's leadership will focus on strengthening the role of the Party, and that reforms will continue to be State-, rather than market-driven.

2.2. BASIC FEATURES OF THE SOCIALIST MARKET ECONOMY

Prior to the launching of the 'Open-door' policy in China in 1978, which opened up for market-oriented economic reforms, the Chinese economy was essentially a closed, state-planned economy, mainly consisting of state-owned and collectively-owned enterprises. The move to a socialist market economy meant a shift from a pure planned economy to a hybrid system.

It is fair to say that while the Chinese economy has developed remarkably in the last forty years and is much more deeply integrated in the global economy, it has developed into an economy that is unlike any other economic system in the world.

In practice, the socialist market economy system has meant that while market forces have been mobilised to some extent, the decisive role of the State remains intact – as reconfirmed in Articles 6 and 7 of the Constitution and subsequent legislation such as Article 1 of the Law on State-Owned Assets in Enterprises. Therefore, even though today the Chinese economy is to some extent made up of non-state actors (for more details see Chapter 5), the decisive role of the State in the economy remains intact, with tight interconnections between government and enterprises (going far beyond the boundaries of SOEs) in place.[18]

The system has been described in the following way:

> *Compared with the Japanese developmental pattern, in which central government agencies simply planned the development process and calibrated industrial policies, China's state capitalism encourages both central and local governments*

[15] Ibid., p. 29.
[16] Ibid.
[17] CCP Constitution, General Programme.
[18] World Bank and the Development Research Center of the State Council, P. R. China. (2013). *China 2030: Building a Modern, Harmonious, and Creative Society*. Washington, DC: World Bank, p. 79.

to play a straightforward role in supporting local industries with various forms of financial aid and services. China's developmental miracle owes much to the socialist heritage of the Maoist era, which instituted a strong Leninist party-state and a concentration of power in the Communist Party of China. This model tends to promote state-owned enterprises (SOEs) at the expense of private actors in pillar industries (zhizhu chanye), but for emerging industries (xinxing chanye) where no national champions can be identified, the local authorities are often ready to offer generous help for these indigenous firms, regardless of their ownership structures.[19]

China has consistently resorted to a top-down interventionist industrial policy as a tool to achieve industrial modernisation and economic goals. The State does so through numerous means. To start with, there is an elaborate system of plans covering practically all aspects of the economy and levels of government (see Chapter 4). Furthermore, it maintains significant ownership stakes in important enterprises in 'strategic' sectors and it deploys a range of direct industrial interventions to influence resource allocation (see Chapter 5, as well as Chapters 9 to 13).[20] Typical instruments used are market access controls, project examination and approvals, land supply approvals, loan approvals, various forms of financial support, industrial guidance catalogues, and licensing. Government procurement is a further tool through which the State exerts considerable influence over the market (see Chapter 7).

2.2.1. STATE OWNERSHIP

Though the government has been announcing and implementing to various degrees reforms ostensibly intended to allow market forces to gradually come into play, government ownership remains widespread and varied (see Chapter 5).

Ownership in sectors considered important (strategic or pillar industries) has traditionally been reserved for Chinese state-owned companies. Although the strict requirement for State ownership has formally been eased, there remains a built-in bias towards State ownership, as explained in more detail in Chapters 5 and 8. In contrast, the division between domestic and foreign is much clearer, with specific regimes and restrictions applying to foreign-invested companies. China has a history of attracting foreign technology by allowing foreign investments in specific sectors, and then not allowing any further entries once the requisite technology has been transferred and the Chinese industry has become competitive (see Chapter 8).

At the same time, the links between the State and economy go beyond mere ownership. The Chinese economy is more complex than a simple division of 'private' and 'state-owned'. Often, privately owned companies have close links to the government, in particular due to the

[19] Chen, G., (2015). China's Solar PV Manufacturing and Subsidies from the Perspective of State Capitalism, *The Copenhagen Journal of Asian Studies* 33(1), p. 90.
[20] World Bank and the Development Research Center of the State Council, P. R. China. (2013). *China 2030: Building a Modern, Harmonious, and Creative Society*. Washington, DC: World Bank, p. 85.

strategic importance of their products.[21] The lines between these companies are often blurred, making it difficult to classify Chinese firms according to ownership. For example, many companies that are classified as private actually consist of mixed ownership, and publicly listed companies in China are typically of this type. At the same time, traditional SOEs have undergone or are in the process of corporatisation (see also Chapter 5). There are also companies in which the State has very limited or no ownership. Chinese company statistics are based on registration data. However, companies will not necessarily be registered in a category that reflects the ultimate ownership.

Therefore, while certain types of State influence pertain only to SOEs, in practice both SOEs and large private companies share many similarities in the areas commonly thought to distinguish SOEs from privately owned companies: market access, receipt of State subsidies, proximity to State power, and execution of the government's policy objectives.[22] In fact, since the introduction of the 'Three Represents' by President Jiang Zemin in February 2000, private entrepreneurs have been welcomed as members of the CCP, thus acknowledging and facilitating their role in helping to implement Party goals.[23] There are also reports that the government, through creating 'special management shares', is pushing some of its largest private tech companies to offer the State a stake in them and a direct role in corporate decisions.[24]

2.2.2. ALLOCATION OF FACTORS OF PRODUCTION

China has moved from a system where essentially all prices are set by the State to a more complex system. For consumer goods, the main item still subject to State price fixing is pharmaceuticals. The government also controls the prices of commodities such as fuel, electric power, and other utilities (see Chapter 10).

Land allocation policies implemented by the State are inefficient and land prices are distorted. The rigidity of the system prevents market mechanisms from playing their role, thus creating deep imbalances (see Chapter 9).

According to a World Bank/Development Reform Commission ('DRC') report, the factors of production are identified as one of the areas in which many significant distortions remain,

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[21] Szepan, M. (2017). Government involvement in the Chinese economy, in S. Heilmann (Ed.). (2017), *China's Political System. Lanham*, Maryland: Rowman & Littlefield, p. 209.
[22] Milhaupt, J. and Zheng; W. (2015). *Beyond Ownership: State Capitalism and the Chinese Firm*, Columbia Law School, http://www.law.columbia.edu/node/5344/beyond-ownership-state-capitalism-and-chinese-firm-curtis-j-milhaupt-and-wentong-zheng (accessed 10 October 2017).
[23] See for example China Daily. (2012). *Entrepreneurs' presence grows at CPC congress*, http://www.chinadaily.com.cn/china/2012cpc/2012-11/12/content_15919473.htm (viewed 20 July 2017).
[24] Yuan, L. (2017). *Beijing Pushes for a Direct Hand in China's Big Tech Firms*, Wall Street Journal https://www.wsj.com/articles/beijing-pushes-for-a-direct-hand-in-chinas-big-tech-firms-1507758314 (Accessed 12 October 2017) and Mak, R. (2017)., *Beijing's closer embrace is bad news for Big Tech*, Reuters https://uk.reuters.com/article/us-china-tech-breakingviews/breakingviews-beijings-closer-embrace-is-bad-news-for-big-tech-idUKKBN1CH0HK (Accessed 16 October 2017).

suggesting much potential for reforms to improve resource allocation.[25] The effects of these distortions are significant given that they generally depress factor prices and, therefore, production costs, thus significantly affecting the incentive structure for producers, investors and exporters.[26]

In Chapter 13 of the 13th FYP titled '*Improve the Modern Market System*', the need for market-oriented reforms related to the factors of production – as well as for the liberalisation of pricing - is recognised:

> *[W]e will ensure that rural collectively owned land designated for business-related construction enters the market on an equal footing with and is subject to the same rights and prices as similarly designated state-owned land. […] We will improve systems for the market-based allocation of land designated for industrial purposes. […]*
>
> *We will reduce government intervention in pricing, […]*

China's labour market also suffers from the inflexibility of State policies. Even though it has been largely transformed, it is not fully reformed due to continued controls on place of residence through the household registration (*hukou*) system – which are still in the process of being relaxed – as well as through the lack of independent trade unions (see Chapter 13).

The State remains completely dominant in finance (see Chapter 6). While the share of bank assets controlled by the five large-scale commercial banks has receded, most of the balance of Chinese bank assets is held in smaller institutions in which the State is the majority or dominant owner.[27]

In short, the government recognizes the need to improve resource allocation but by doing so it acknowledges that market principles are currently far from fully working.

2.2.3. INDUSTRIAL INTERVENTIONS

The various FYPs list a multitude of economic goals that China wants to achieve (see Chapter 4). In order to achieve these goals, the government uses a broad range of support measures which include tax incentives, granting of licenses, regulatory approvals, funding and subsidisation**.** These support measures are deployed to achieve the supply of various raw materials, the development of certain segments of industrial sectors (including by supporting the development of new products and encouraging certain industry configurations – notably the creation of larger companies or the relocation of industries) etc. These are also

[25] World Bank and the Development Research Center of the State Council, P. R. China. (2013). *China 2030: Building a Modern, Harmonious, and Creative Society*. Washington, DC: World Bank, p. 79.
[26] Huang, Y. and Wang, B. (2010). Cost Distortions and Structural Imbalances in China. *China & World Economy*, Vol. 18, No. 4, pp. 1-17, p. 11.
[27] Lardy, N. (2014). *Markets over Mao, The Rise of Private Business in China*, Peterson Institute for International Economics, p. 33.

considerations that play a role in the various investment screening processes as described in more detail in Chapter 8.

The State also makes frequent use of catalogues in its industrial policy (see in particular Chapters 4 and 8). For example, following the announcement of the Strategic Emerging Industries ('SEIs') in 2010, China subsequently issued additional policy documents and catalogues explaining the development priorities for key technologies and products considered to be SEIs, identifying specific sub-sectors, technologies and products in each SEI sector, and setting forth a variety of specific policies and support measures designed to spur development in each sub-sector. One of these documents, a catalogue issued by the Ministry of Industry and Information Technology ('MIIT'), instructed sub-central government authorities to identify firms, technologies and measures supporting the central government's SEI initiative, listed relevant companies and research and development units for each sub-sector, and further indicated that the list should be used by other Chinese government ministries to '*issue targeted supporting fiscal and taxation policies*'. Only a very small number of companies listed had any foreign investment, as the list was dominated by Chinese-invested companies, particularly SOEs and domestic national champions.[28] By January 2013, China had created a central government-level support fund for SEI development while encouraging local governments to establish their own local SEI support funds. Another example involves the high-end equipment-manufacturing sector. In this sector, China maintains central, provincial and local government measures that condition the receipt of subsidies on an enterprise's use of at least 60% Chinese-made components when manufacturing intelligent manufacturing equipment.[29]

On investment, while China has indicated that it is easing up on administrative approvals,[30] and is moving towards a system of negative lists, the 'Catalogue for the Guidance of Foreign Investment Industries' still remains. This Catalogue indicates which sectors are encouraged, restricted and prohibited for foreign enterprises to invest in, but also under which conditions (joint-venture requirements, etc.) investments in are allowed. These catalogues are designed to be closely in line with more overarching industrial policy goals. Catalogues are also commonly used in government procurement (see Chapter 7).

In conclusion, and as discussed throughout this report, Chinese industrial policy is demonstrably interventionist and there is no sign that this will change in the foreseeable future. A broad range of policy tools is available for the State to implement governmental targets.

[28] USTR. (2016). 2016 Report to Congress On China's WTO Compliance, p. 60.
[29] Ibid.
[30] Which it has done regarding approvals of outbound investments.

2.2.4. COMPETENCES OF PROVINCIAL AND MUNICIPAL GOVERNMENTS

Chinese local government consists of several levels (from higher to lower): province, municipality (or prefecture), county, and township. As of 2017, China administers 33 provincial-level regions (not including Taiwan), 334 prefecture-level divisions, 2 862 county-level divisions, 41 034 township-level administrations, and 704 382 village-level subdivisions.[31] In the following, the term 'local government' is used to refer to levels of government other than the central government.

The role of the local government in economic development in China is substantive. The Chinese government system is highly centralized in official appointments but, at the same time, quite decentralized in economic development activities. The central government controls the power over regulation, resource allocation, quotas, and approval of numerous activities; the central level, however, relies on the cooperation of local governments in implementing and achieving the set policy goals. As regards the process of development planning and implementation, the central government sets the national growth targets as specified in the FYPs. All major officials are appointed by their higher level governments and these appointees serve the development targets. Prospects of promotion of officials depend on the growth rate and each official has the incentive to achieve (even exceed) the set growth targets.[32]

While lower levels of government have to implement and to further elaborate the policies decided at higher levels, this does not exclude that these sub-national levels might also pursue their own goals and these goals are not necessarily in harmony with those pursued at higher levels. In the early days of opening up, market-oriented reforms were introduced in a gradual, experimental way, with the central government providing incentives for local governments[33] as well as delegating significant autonomy. This has led to sub-national governments becoming important players in the Chinese economy in their own right, in many cases through ownership of companies, but also as regulators and through implementation of central industrial policies. As such, there has been no real division of functions and there is also a certain competition between provincial/municipal governments, making regional competition a major component. This has led to a multiplication and reinforcement of policies which in many cases are not driven by market considerations, and has also contributed to significant overcapacities in a number of sectors.[34]

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[31] See State Council website, 中华人民共和国行政区划, http://www.gov.cn/guoqing/2005-09/13/content_5043917.htm (accessed on 16 October 2017).
[32] Hou, Y. and School, M. (2016). *Interpreting China's Fiscal Reforms and the 13th Five-Year Plan Targets*, Syracuse University April 27, 2016, Testimony before the U.S.-China Economic and Security Review Commission (USCC), p 6.
[33] World Bank and the Development Research Center of the State Council, P. R. China. (2013). *China 2030: Building a Modern, Harmonious, and Creative Society*. Washington, DC: World Bank, p. 4.
[34] European Chamber of Commerce in China, (2016). *Overcapacity in China – an impediment to the government's reform agenda*, p. 10.

2.2.5. OVERCAPACITY

While overall Chinese policy has also aimed to curtail overcapacity, in fact, Chinese industrial policy has led to the opposite, resulting in very large overcapacities in a number of sectors – often characterised by a high share of SOEs – such as steel, aluminium, ceramics, and wind power (see e.g. Chapters 14 and 15). It has not been uncommon that while the central government focuses on curbing a sector riddled by overcapacity, a local government will at the same time seek to maintain or develop that sector into one of its pillar industries. Central and local governments are not always aligned. Duplication of industrial policies is also a common cause of overcapacity. Additionally, if specific industries are encouraged, local subsidies and tax relief for companies often lead to overinvestment.[35] Government policies additionally have kept input prices low in order to stimulate the secondary sectors, in particular heavy industry.[36] As a result, efforts to reduce overcapacity have fallen short of expectations.

2.2.6. CONSOLIDATION

Chinese industrial policy has furthermore been focused on the consolidation of companies in fragmented industries, in particular in the area of SOEs, with recent examples to be found in such sectors as shipping, railway equipment, steel and industrial equipment. The restructuring of SOEs tends to result in consolidation through mergers, rather than bankruptcy (see Chapter 5.5.1).

Closely linked is the aim to create Chinese national champions. The Chinese government has been and remains focused on the creation of large companies that are technologically advanced. One of the tasks of SASAC was to transform SOEs into large national champions.[37] Originally such companies were expected to be competitive only on the Chinese market, but global competitiveness has increasingly become the target.[38]

2.2.7. UPGRADING OF THE ECONOMY

From the mid-2000s onwards, the central government began to publicly focus its efforts on upgrading the economy away from traditional industries reliant on low-skilled labour. As such, China's industrial policies have become closely linked to China's innovation policies. In 2006, the State Council issued the Medium- and Long-term Strategic Plan for the Development of Science and Technology (2006-2020) as well as its ensuing implementing Decision.[39] Amongst the targets were that science and technology should contribute 60% to

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[35] For a more detailed analysis of local-level industrial policies, see European Chamber of Commerce in China, (2009). *Overcapacity in China, Causes, Impacts and Recommendations*, p. 14.
[36] European Chamber of Commerce in China, (2009). *Overcapacity in China, Causes, Impacts and Recommendations*, p. 16, 17.
[37] Heilmann, S., Shih, L. (2017). in Heilmann, S. (Ed.), (2017). *China's Political System.* Lanham, Maryland: Rowman & Littlefield, p. 79.
[38] See for example the Made in China 2025 initiative.
[39] National Long-term Plan for the development of Science and Technology 2006-2020, published 9th February 2006, 国家中长期科学和技术发展规划纲要（2006-2020 年）http://www.gov.cn/jrzg/2006-

the economy in 2020, and that the degree of reliance on foreign technology should drop to 30%. This was closely linked to subsequent initiatives on indigenous innovation and government procurement.

China inter alia identifies specific industry sectors as priority sectors for technological advancement, setting targets for their expected future share of gross domestic product ('GDP'). In the 2010 State Council Decision on Accelerating the Development of Strategic Emerging Industries, the Chinese government identified seven SEIs[40] to be the priority of industrial upgrading. The industries were to be promoted through tax and financial incentives. [41] Some central and sub-central government measures use local content requirements as a condition for enterprises in SEI sectors to receive financial support or other preferences. For example, in the high-end equipment-manufacturing sector, China has maintained an annual program that conditioned the receipt of a subsidy on an enterprise's use of at least 60% Chinese-made components when producing intelligent manufacturing equipment.[42]

This development has continued through subsequent FYPs and industrial plans issued at both central and local level. The central 13th FYP focuses on the creation of a '*moderately prosperous society*' through innovative, coordinated, green, open and sustainable growth (see Chapter 4.2.7). Innovation is emphasised as a key driver of growth. The government is seeking to use innovation to accelerate efforts to move Chinese manufacturing up the value chain, establish China as a global centre of innovation and technology, and ensure long-term productivity. The principal beneficiaries of these constantly evolving policies are SOEs, as well as other favoured domestic companies attempting to move up the economic value chain.[43] Major examples of recent industrial plans include the Made in China 2025 policy, which stresses concepts such as indigenous innovation and self-sufficiency in as many as ten strategic technological sectors and is associated with significant government funding.

2.3. CHAPTER SUMMARY

The preamble of the Constitution, some further provisions in the Constitution, the CCP Constitution as well as various other legal acts and documents refer to the term 'socialist market economy' and elaborate on its meaning.

02/09/content_183787.htm and State Council Decision on the implementation of the Science and Technology Plan and on Strengthening indigenous innovation capacities, published 10th February 2006, 中共中央国务院关于实施科技规划纲要增强自主创新能力的决定 http://www.most.gov.cn/yw/200602/t20060209_28641.htm (accessed 16 October 2017).

[40] Energy efficient and environmental technologies, next generation information technology, biotechnology, high-end equipment manufacturing, new energy, new materials, and new-energy vehicles.

[41] Under Heading VII, the Guidelines specifically mention enhancing financial support and setting up specific funds, improving tax incentive policies, and encouraging financial institutions to offer more credit support.

[42] USTR; 2016 Report to Congress on China's WTO Compliance, p. 15.

[43] Ibid., p. 11.

The term ‘socialist market economy’ replaces the denomination used prior to 1993, i.e. ‘planned economy’, and is at the heart of the Chinese economic system. The words 'market economy' are qualified by the adjective ‘socialist’. This adjective has important legal and practical consequences.

While the Constitution itself recognises that diverse forms of ownership develop side by side, and while the Chinese economy consists to a large extent of non-state actors, the party and the State retain nevertheless a leading role in the economic governance of the country.

Furthermore, the involvement of the State and the Party go clearly beyond broad macroeconomic control. For example, the text of Article 11 of the Constitution stipulates that the State not only encourages and supports the development of the non-public sectors of the economy but that it also guides that development. The law on state-owned enterprises refers to ‘*consolidating and expanding the State-owned sector*' and to '*giving play to the leading role of the State-owned sector in the national economy*’. Also various planning documents that are analysed in more detail in chapter 3 and elsewhere refer to the dominant role of the State-economy. The State has even released plans for the private economy. At the 19th Party Congress, decisions were made to strengthen the Party’s leadership over ‘all work’.

Hence, this unique economic system grants the State, as well as the CCP, a decisive role in the economy. The leadership role of the CCP and its all-encompassing controls are inherent in China's official designation as a socialist market economy.[44] The basic features of the socialist market economy are a dominant state-ownership, which the State and the party wish to further strengthen and expand e.g. by the creation of national champions, an extensive and sophisticated economic planning system, an interventionist government policy in the economy in order to implement these plans by using a broad array of tools, including guiding catalogues, investment screening, financial incentives etc. There are very close linkages between these features as they all appear to follow the same goal of tight control by the State on the economy. All this leads to non-market based resource allocations and to the creation of overcapacities in many sectors.

[44] Houtari, M., Heep, S., Heilmann, S. (2017). *The dynamics of a developmental state,* in Heilmann, S. (Ed.) (2017), *China’s Political System.* Lanham, Maryland: Rowman & Littlefield, p. 239.

3. CHINESE COMMUNIST PARTY

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3.1. LEADERSHIP OF THE CCP

The CCP is the only governing party of China. According to a communiqué issued by the CCP in June 2017, CCP membership stood at more than 89 million members at the end of 2016.[45] The power of the CCP rests upon controlling the armed forces, appointing cadres and the media. The CCP also has a tight grip on the judiciary.

The leadership of the CCP is affirmed in the preamble of the Constitution:

> *Under the leadership of the Communist Party of China and the guidance of Marxism-Leninism, Mao Zedong Thought, Deng Xiaoping Theory and the important thought of Three Represents, the Chinese people of all nationalities will continue to adhere to the people's democratic dictatorship and the socialist road […]*

The CCP is not mentioned in any of the subsequent provisions of the Constitution. By referring to the leadership of the CCP, Marxism-Leninism, Mao Zedong Thought, and adhering to the socialist road and the people's democratic dictatorship, the Constitution's preamble to a large extent mirrors the General Program of the CCP Constitution, which states:

[45] China Daily. (2017). *Infographic: CPC members in numbers*, 5 July 2017. http://www.chinadaily.com.cn/china/2017-07/05/content_29994440.htm (accessed 1 August 2017).

> *The Four Cardinal Principles - to keep to the socialist road and to uphold the people's democratic dictatorship, leadership by the Communist Party of China, and Marxism-Leninism and Mao Zedong Thought - are the foundation on which to build the country. Throughout the course of socialist modernization the Party must adhere to the Four Cardinal Principles and combat bourgeois liberalization.*

Both Constitutions reconfirm the role of the CCP and its ideologies in leading China. Ideology matters more in China than in many other political systems.[46]

The 'Four Cardinal' principles are sacrosanct in Chinese politics, and are seen as a '*fundamental guarantee for the sound development of China's socialist modernization*'.[47]

The General Program of the CCP Constitution also makes clear that economic development is the central task of the Party:

> *In leading the cause of socialism, the Communist Party of China must persist in taking economic development as the central task, making all other work subordinate to and serve this central task.*

Furthermore, the General Program of the CCP Constitution clearly states that it is for the CCP to develop the socialist market economy (See Chapter 2) as well as to guide the public and private sectors in the economy:

> *The Party must fundamentally reform the economic structure that constrains the development of the productive forces and uphold and improve the socialist market economy; and in congruence with this it must undertake political structural reform and reform in other fields.*
>
> *The Communist Party of China shall lead the people in developing the socialist market economy. It shall be firm in consolidating and developing the public sector of the economy and shall remain steadfast in encouraging, supporting, and guiding the development of the non-public sector.*

It follows that the CCP dominates the State, society and the economy

3.2. Relationship between State and Party

China's government is officially run by the State Council, a structure which is matched step by step by the organisation and structure of the Party, at each level of government, from the central level down to the village level. Decisions by State institutions must follow guidelines established by the party committees or party groups established within the State institutions.

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[46] Lawrence, S.V. and Martin, M.F. (2013). *Understanding China's Political System*, Congressional Research Service, p. 11.

[47] *Four Cardinal Principles* (Mar. 1979), http://www.china.org.cn/china/CCP_90_anniversary/2011-06/22/content_22838756.htm (accessed 20 July 2017).

In recent years the CCP itself has been taking a more direct role in policy formulation, and even implementation.[48] This was made especially clear in the keynote speech made by party general secretary Xi Jinping at the recently convened 19th party congress, when he emphasized that 'the party should exercise leadership over all work'.[49]

The highest organ of State power is the NPC. Its role is defined in Article 57 of the Constitution:

> *The National People's Congress of the People's Republic of China is the highest organ of state power. Its permanent body is the Standing Committee of the National People's Congress.*

Article 62 formally grants the NPC extensive powers, such as amending the Constitution; supervising its enforcement; enacting and amending laws; electing top officials including the President and Vice-President, deciding questions of war and peace; approving FYPs and many other functions pertaining to the most important State decisions.

In reality, however, the NPC exercises many of those powers in name only. One major reason for this is the CCP's insistence that it essentially 'ratifies' Party decisions.[50] Even though the role of the NPC was formally strengthened in the 1990's, in fact apart from delaying the enactment of certain laws, it seems to have few real powers to exert influence in Chinese politics.[51] This was clearly stated in the 18th Party Congress Work Report in 2012: '*We should make good use of legal procedures to turn the party's propositions into the will of the State […] We should place greater emphasis on improving the way the Party exercises leadership and governance to ensure that it leads the people in effectively governing the country*.'[52]

The links between the Party and the State are intimate not least because on average around 70% of NPC delegates hold concurrent posts in the CCP.[53] Moreover, more than two-thirds of the delegates to the NPC are put forward by the CCP.[54]

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[48] Johnson, C.K. and Kennedy, S. (2015). China's Un-Separation of Powers - The Blurred Lines of Party and Government, in *Foreign Affairs*, https://www.foreignaffairs.com/articles/china/2015-07-24/chinas-un-separation-powers (accessed 16 October 2017).
[49] 光明日报评论员：坚持党对一切工作的领导—论深入学习贯彻党的十九大精神, http://cpc.people.com.cn/n1/2017/1028/c64387-29613795.html (accessed on 24 November 2017).
[50] Lawrence, S.V., and Martin, M.F. (2013). *Understanding China's Political System*, Congressional Research Service, p. 7.
[51] Saich, T. (2015). *The National People's Congress: Functions and Membership*, Harvard Kennedy School, Ash Center for Democratic Governance and Innovation, p. 10. http://ash.harvard.edu/files/ash/files/the_national_peoples_congress.pdf (accessed on 18 August 2017).
[52] Report of Hu Jintao to the 18th CPC National Congress, http://www.china.org.cn/china/18th_cpc_congress/2012-11/16/content_27137540_5.htm (accessed on 10 October 2017).
[53] Ibid, p.4.
[54] Heilmann, S., Stepan, M. (2017). in Heilmann, S. (Ed.) (2017), *China's Political System.* Lanham, Maryland: Rowman & Littlefield, p. 130.

Furthermore, top officials at each level of the State system hold concurrent CCP posts, and party committees are embedded in the State Council, ministries, and government departments at every level.[55] Furthermore, CCP leaders often act through their constitutional identities as government officials rather than as Party cadres. As such, government and CCP personnel remain in many ways fused, and the practical distinction between the two can be very difficult to discern.[56] As a result, while the government is officially run by the State Council and its ministries, in practice, there is no separation of powers as such, leaving the CCP and State practically indistinguishable.[57]

3.3. APPOINTMENTS

A key pillar of the CCP's power is its control of personnel appointments across all political institutions, the military, SOEs, and public institutions. The CCP will essentially appoint all senior personnel in government and administrative bodies, centrally as well as regionally. This is done through the so-called cadre system. The CCP Organisation Department is the body in the Party bureaucracy responsible for the recruitment of Party members and their training, as well as assignments and appointments. The importance of the appointment and management of cadres was emphasized at the 18th Party Congress: '*To uphold and build socialism with Chinese characteristics, it is imperative to build a contingent of key officials for governance who are firm in political conviction, competent and energetic and have fine conduct. We should adhere to the principle of the Party supervising the performance of officials.*'[58]

The Organisation Department organises cadres according to rank. This party ranking supersedes any ranking in the State system. For example, SOE leaders sometimes outrank the Party and government leaders in the geographic jurisdictions in which they are based, making

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[55] Lawrence, S. (2013). *China's Political Institutions and Leaders in Charts*. Congressional Research Service, p. 4.

[56] Ip, E.C. (2011). *The Supreme People's Court and Judicial Empowerment in China*, p. 379, in Columbia Journal of Asian Law.

[57] This is also confirmed by China's official sources. See for example statement from March 2017 of Wang Qishan, member of the Standing Committee of the Central Political Bureau of the CPC and Secretary of the Central Commission for Discipline Inspection at the time: '*In China's history and tradition, "government" is always understood as a broad concept, undertaking unlimited responsibility. The Party's organs, the NPC's organs, the administrative organs, the CPPCC's organs as well as the courts and prosecutors' offices are seen by the general public as all being the government. Under the leadership of the Party, there is no separation between the Party and the Government, there is only a division of work between the Party and the Government: on this matter, we must have a clear stand, be straightforward and be resolutely confident in the way, the theory, the system and the culture of Socialism with Chinese characteristics.*' Xinhua, 王岐山：构建党统一领导的反腐败体制 提高执政能力 完善治理体系, http://news.xinhuanet.com/politics/2017lh/2017-03/05/c_1120572195.htm (accessed on 7 December 2017).

[58] Report of Hu Jintao to the 18th CPC National Congress, http://www.china.org.cn/china/18th_cpc_congress/2012-11/16/content_27137540_12.htm (accessed on 10 October 2017).

it impossible for the local government to issue binding orders to them,[59] and it is not unusual that SOE managers move between enterprises and government functions (see also Chapter 5.5.2 and 5.5.3). Investigations into the individual backgrounds of the members of the boards of directors and the supervisory councils of major industrial enterprises have revealed that a large majority of them are not only Party members, but also hold senior positions in the government and CCP hierarchy or have done so prior to serving in the corporate sector.[60]

Leaders of the largest private firms are not part of the cadre system. However, this does not mean that they are outside the Party system. In 2002, the Party formally welcomed private business leaders. According to the CCP, around 25% of its members are professionals and managers.[61]

3.4. PARTY ORGANISATIONS IN ALL AREAS OF THE STATE AND THE ECONOMY

One of the ways in which the CCP keeps control is through the creation of Party organisations (also referred to as Party cells, or Party committees) in virtually all areas of society. According to the CCP's 2016 figures, such Party organisations exist in 67.9% of all private enterprises (including foreign-invested enterprises), and in 91.3% of all SOEs.[62] They can potentially wield significant influence, and allow for the CCP to directly influence the business decisions of individual companies. The legal framework backs up this influence.

Articles 30 and 32 of the CCP Constitution state that primary Party organisations are to be formed in units which contain three full Party members:

> *A primary-level Party organisation shall be formed in any enterprise, […], and any other primary-level danwei [an organisation where people work] where there are three or more full Party members.*
>
> *Primary-level Party organisations shall, according to the requirements of their work and Party member numbers, and with the approval of higher-level Party organisations,*
>
> *establish primary-level Party committees, general Party branch committees, or Party branch committees. A primary-level Party committee is elected through a general meeting or a meeting of delegates and a general Party branch committee or a Party branch committee is elected through a general meeting, and in*

[59] Lawrence, S.V., and Martin, M.F. (2013). *Understanding China's Political System*, Congressional Research Service, p. 15.
[60] Taube, M. and Schmidkonz, C. (2015). *Assessment of the normative and policy framework governing the Chinese economy and its impact on international competition*, Report preparedby THINK!DESK China Research& Consulting for AEGIS EUROPE, p. 246. For more detailed examples, please see pp. 247-248.
[61] Xinhua. (2017). *Backgrounder: Five things you need to know about CPC*, 1 July 2017, http://www.china.org.cn/china/Off_the_Wire/2017-07/01/content_41135252.htm (accessed on 16 october 2017).
[62] See China Daily. (2017). *Infographic: CPC members in numbers*, available at: http://www.chinadaily.com.cn/china/2017-07/05/content_29994440.htm (accessed on 16 October 2017).

nominating candidates for these committees, the opinions of both Party and non-Party members shall be widely solicited. [63]

Primary-level Party organisations play a key role for the Party in the basic units of social organisation; they are the foundation for all the Party's work and for its capacity to take on challenges. Their main tasks are:

1) to communicate to the public and carry out the Party's lines, principles and policies, the resolutions of the Party Central Committee and other higher-level Party organisations, and their own resolutions; to give full play to the exemplary and vanguard role of Party members, to excel in their work, and to unite and organize Party officials and non-party officials as well as Party members and non-party members to fulfil the tasks of their danwei.

7) to ensure that Party officials and all other personnel strictly observe state laws and regulations and the state's financial and economic statutes and regulations on personnel, and that they do not infringe on the interests of the state, collectives, or the people.[64]

3.4.1. PARTY ORGANISATIONS IN ENTERPRISES

The CCP Constitution contains specific provisions for SOEs. It empowers the Party organisation with an extensive role in the operation of an SOE, including supporting the meetings of shareholders, board of directors, board of supervisors and management. According to Article 33, the Party organisation is further empowered to participate in final decisions in an enterprise:

The leading Party members groups or Party committees of state-owned enterprises shall play a leadership role, […], ensure the implementation of Party policies and principles, and discuss and decide on major issues of their enterprise in accordance with regulations. Primary-level Party organisations in state-owned or collective enterprises should focus their work on the operations of their enterprise. Primary-level Party organisations shall guarantee and oversee the implementation of the principles and policies of the Party and the state within their own enterprise and shall support the board of shareholders, board of directors, board of supervisors, and manager (or factory director) in exercising their functions and powers in accordance with the law. They shall […] participate in making decisions on major issues in the enterprise. […]

In the case of non-public entities, the CCP Constitution also has bestowed the Party organisation with considerable influence. In particular, according the Article 33, the Party organisation exercises leadership over labour unions.

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[63] See CCP Constitution, Article 30.
[64] See Ibid., Article 32.

> *Primary-level Party organisations in non-public sector entities shall implement the Party's principles and policies, guide and oversee their enterprises' observance of state laws and regulations, exercise leadership over trade unions, Communist Youth League organisations, and other people's group organisations, promote unity and cohesion among workers and office staff, safeguard the legitimate rights and interests of all parties, and promote the healthy development of their enterprises.*

The creation of party organisations is reconfirmed in relevant legislation – approved by the NPC – such as in Article 19 of the Company Law:

> *In a company, an organisation of the Communist Party of China shall be established to carry out the activities of the party in accordance with the charter of the Communist Party of China. The company shall provide the necessary conditions for the activities of the party organisation.*

While the requirement to create Party organisations has been a constant in legislation such as the Company Law, it appears to not always have been followed or strictly enforced. However, in the last year, the CCP has issued a number of statements and measures meant to not only ensure the creation of Party organisations, but also to strengthen their role in the business activities of both public and non-public entities.[65]

The increased presence of the Party has become particularly visible in the case of SOEs. While the State Council has approved an action plan to reform SOEs,[66] more than 30 Hong Kong-listed state-owned enterprises, representing more than USD 1 trillion, have adjusted their articles of association to grant the Party a more visible role.[67]

The specific example below is taken from China Railway Group, but in general, the changes in the articles of association follow a similar model for all companies.[68] A specific chapter is introduced on the creation of a Party committee, which for China Railway Group contains the following elements (Chapter 17, Articles 251-253):[69]

> *Article 251*
>
> *Pursuant to the Constitution of Communist Party of China, the Company shall establish an organisation of the Communist Party of China ("Party"), which shall*

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[65] See e.g. Hornby L. (2017) Communist party assets control over China Inc. Financial Times. https://www.ft.com/content/29ee1750-a42a-11e7-9e4f-7f5e6a7c98a2 (accessed on 14 December 2017).
[66] Action plan to reform central SOEs toward corporations, 26 July 2017, http://english.gov.cn/policies/latest_releases/2017/05/03/content_281475644421269.htm (accessed on 12 October 2017).
[67] Hughes, J. (2017). *China's Communist party writes itself into Company Law,* Financial Times, 14 August 2017, https://www.ft.com/content/a4b28218-80db-11e7-94e2-c5b903247afd (accessed on 10 October 2017)
[68] See Chapters 15 (aluminium) and 6 (financial system) for further examples.
[69] Articles of Association of China Railway Group Limited (Amended in June 2017), http://www.hkexnews.hk/listedco/listconews/SEHK/2017/0628/LTN20170628958.pdf (Accessed on 12 October 2017).

> *play the role as the core of leadership, and the political nucleus, and take charge of the direction and overall situation and ensure the implementation of policies. The Company shall establish a work institution of the Party with a sufficient number of personnel responsible for the Party affairs and guarantee the working funds of the Party organisation.* (emphasis added)

In principle, the chairman of the board and the head of the Party committee is expected to be the same person.[70]

The articles of association then further expand as to what role the Party organisation is expected to play in relation to the CCP and its regulations, including the CCP Constitution. This includes the monitoring of CCP and State policies, but also the practical implementation of Party decisions in the company. There is also a direct referral to the role of the SASAC Party committee:

> *To monitor the implementation of the principles and policies of the Party and of the State within Company, and to implement material strategic decisions made by the Central Committee of the Party and the State Council as well as important work deployment assigned by the Party committee of the State-owned Assets Supervision and Administration Commission and Party organisations of higher levels.* [71]

The Party committee is furthermore tasked to play a decisive role in the selection and evaluation of officials, together with the board of directors:

> *To persist in combining the principle of the Party supervising the performance of officials with the legitimate selection by the board of directors of the managers and the legitimate use of human resources by the managers. The Party Committee shall consider and provide opinions on the candidates nominated by the board of directors or the president, or recommend nominees to the board of directors or the president; evaluate the proposed candidates in conjunction with the board of directors, collectively consider and make suggestions.*[72]

In addition, the Party committee is to be involved in key management decisions of the company:

> *To consider and discuss the matters on the reform, development and stability of the Company, major operation and management matters as well as key issues involving the vital interests of employees, and make suggestions.*[73]

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[70] See for example Article 99 in the revised articles of association for China Aluminum International Engineering Corporation Limited (Chalieco) (Chapter 15).
[71] Articles of Association of China Railway Group Limited, Article 253 (1).
[72] Ibid., Article 253 (2).
[73] Ibid., Article 253 (3).

The Party committee is also explicitly tasked with taking 'the full responsibility for the strict discipline of the Party'.[74]

Changes have also been made to the provisions concerning the board of directors, stating that the Party committee has to be consulted before material issues are decided upon:

> *When the board of directors decides on material issues, it shall first listen to the opinions of the Party Committee of the Company.*[75]

In a speech made in October 2016, President Xi Jinping stressed the role of the party in SOEs, underlining that party leadership and building the role of the party are *'the root and soul'* for SOEs and that the *'major political principle'* of CCP's leadership in SOEs must be insisted on.[76]

In July 2017, the CCP issued a revised regulation on inspection,[77] further strengthening the rule of the Party. The regulation envisages that '*political inspection should be deepened, and inspections should mainly focus on upholding the Party leadership, improving Party building, and advancing comprehensive and strict rule of the Party'*. The amended regulation stipulates that '*Party committees at central, provincial level or at the level of the autonomous regions and direct-controlled municipalities shall implement an inspection system, set up a structure dedicated to inspections and proceed, during their mandate, to comprehensive inspections of the Party's organisations in any locality, department, public institution or enterprise under their jurisdiction.'* [78] (emphasis added) In other words, the control extends to the Party organisations in enterprises and hence it covers also the organisations' supervision of enterprises.

The Action Plan for Corporate Reform of Central Enterprises[79] issued by the State Council on the 18th of July 2017 reaffirms the role of the Party in the restructuring process of the enterprises:

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[74] Ibid., Article 253(4).
[75] Ibid., Article 155.
[76] Xinhua. (2016). *Xi stresses CPC leadership of state-owned enterprises*, 11.10.2016: http://news.xinhuanet.com/ english/2016-10/11/c_ 135746608.htm (accessed on 23 August 2017).
[77] CCP's amending decision on 'the conditions applicable to the CCP inspection work' 01st July 2017, 中共中央关于修改《中国共产党巡视工作条例》的决定 （2017 年 7 月 1 日） http://www.ccdi.gov.cn/xwtt/201707/t20170714_102917.html (accessed on 23 August 2017).
[78] CPC issues revised regulation on inspection to strengthen Party supervision, Xinhua, 14.07.2017, http://news.xinhuanet.com/english/2017-07/14/c_136444780.htm (accessed on 23 August 2017).
[79] State Council General Office's Notice regarding the publication of the Action Plan for a Corporate Reform of Central Enterprises , 2017/69 国务院办公厅关于印发中央企业公司制改制工作实施方案的通知, 国办发〔2017〕69 号, http://www.gov.cn/zhengce/content/2017-07/26/content_5213271.htm (accessed on 23 August 2017) http://english.gov.cn/policies/latest_releases/2017/07/26/content_281475754202054.htm (accessed 16 October 2017).

4. Overall coordination and progress

(1) Party leadership shall be strengthened. The Party committee (group) of a central enterprise shall earnestly strengthen the organisation and leadership of the restructuring work, […]. It is imperative to give full play to the core leadership and political role of the Party organisation of a central enterprise to ensure that Party leadership and Party building are fully embodied and effectively strengthened during enterprise restructuring; […] and promptly report the major issues encountered during restructuring to the CPC Central Committee and the State Council.

(2) […] A restructured enterprise shall also adhere to two unwavering principles that the Party shall always have leadership over SOEs and that the direction of SOE reforms is to establish the modern enterprise system, unify the efforts to strengthen Party leadership with those to improve corporate governance, […]

For further examples of the increasing role of party organisations in individual companies, see Chapter 6.7 for the banking sector and Chapter 15 for the aluminium industry.

In 2017, foreign-invested companies have also encountered increased pressure to create Party committees. There are reports that some companies are under 'political pressure' to revise the terms of their joint ventures with state-owned partners to allow the party final say over business operations and investment decisions.[80]

The Party has also been making inroads in relation to private companies. On 8 September 2017, The CCP and the State Council released the *Opinions on Creating a Healthy Environment for the Development of Entrepreneurs, Promoting Entrepreneurship and Allowing Full Play to the Role Played by Entrepreneurs*. According to the Opinions, the quality, efficiency and pragmaticality of entrepreneur services should be improved to step up entrepreneur cultivation and strengthen the party's leadership on entrepreneurs, and invites entrepreneurs to engage with the Party committees, put patriotism first and follow the Party discipline.[81]

3.4.2. PARTY ORGANISATIONS IN GOVERNMENTAL AND NON-PUBLIC ENTITIES

The CCP Constitution further allows for the formation of leading Party Member's groups in governmental and non-public organisations. According to Articles 48-50 of the CCP

[80] Martina, M. (2017). *In China, the Party's push for influence inside foreign firms stirs fears,* Reuters, 24 August 2017, https://www.reuters.com/article/us-china-congress-companies/exclusive-in-china-the-partys-push-for-influence-inside-foreign-firms-stirs-fears-idUSKCN1B40JU (accessed on 10 October 2017).
[81] Opinions on Creating a Healthy Environment for the Development of Entrepreneurs, Promoting Entrepreneurship and Allowing Full Play to the Role Played by Entrepreneurs, http://www.gov.cn/zhengce/2017-09/25/content_5227473.htm (accessed on 12 October 2017).

Constitution, these groups are granted the *de facto* – or core – leadership of such organisations:

> *A leading Party members group may be formed in the leading body of central or local state organs, people's organisations, economic or cultural institutions, or other non-Party organisations. Such a group shall play the role of the leadership core. Its main tasks are: to ensure that the Party's lines, principles, and policies are implemented; to strengthen leadership over Party building within its danwei and fulfil its responsibility for exercising strict Party self-governance in every respect; to discuss and make decisions on matters of major significance within its danwei, to manage officials to proper effect; to discuss and decide on important issues including adjusting the setup of primary-level Party organisations, admitting new Party members, and disciplining Party members; to encourage non-Party officials and the people in fulfilling the tasks entrusted to them by the Party and the state; and to exercise leadership over the work of the Party organisations of the danwei and those directly under it.*[82]
>
> *The composition of a leading Party members group is decided on by the Party organisation that approves its establishment. A leading Party members group shall appoint a secretary and, when necessary, deputy secretaries. A leading Party members group must accept the leadership of the Party organisation that approves its establishment.*[83]
>
> *Party committees may be set up in state departments which exercise centralized leadership over the danwei beneath them. The Central Committee of the Party shall stipulate the specific procedures for their establishment and define their functions, powers, and tasks.*[84]

Party organs are embedded within the ministries and government bodies, and play a decisive role in the internal decision making processes. For instance, the Party group, which contains the senior leaders of the ministry, will meet once a week. They are the core decision-makers of the ministry. With very few exceptions, leading government representatives tend to be Party members.[85]

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[82] See CCP Constitution, Article 48.
[83] Ibid., Article 49.
[84] Ibid., Article 50.
[85] Lawrence, S. and Martin, M. (2013). *Understanding China's Political System.* Congressional Research Service, p. 28.

Furthermore, civil servants are obliged to adhere to carry out the policy of the Party, according to Article 4 of the Law of the People's Republic of China on Public Servants[86], which states:

> *In application of the public servant system, Marxism-Leninism, Mao Zedong Thought, Deng Xiaoping Theory and the important thought of "Three Represents" shall be upheld as the guidance, the basic line for the primary stage of socialism shall be implemented, the cadre line and policy of the Communist Party of China shall be carried out, and the principle that cadres are under the administration of the Party shall be adhered to.*

The Party's presence in both governmental as well as non-public units has been strengthened in recent years. In 2013, the 3rd Plenum Decision provided for a crucial role for the CCP: '*To completely deepen reform, we must strengthen and improve the party's leadership, fully give rein to the overall picture in which the party assumes all responsibility, coordinate its leading core function in all areas,* […] *raise the party's leadership levels and governance capacity so as to ensure that success is achieved in reform'*. It also refers to the well-established informal system of leading small groups: '*The central authorities establish a Leading Small Group for the Comprehensive Deepening of Reform, to be responsible for the general design, comprehensive coordination, overall pushing forward and stimulating implementation of reform.*'[87] In May 2015, the Political Bureau of the CCP passed a regulation in order to strengthen the system of Leading Party members' groups in state organs, organisations and non-Party units in guaranteeing the implementation of the line and policies of the Party.[88]

3.4.3. INDUSTRY ASSOCIATIONS

Industry associations, many of which are the remnants of abolished ministries,[89] have traditionally played a large and influential role in the Chinese market, in particular in traditional sectors such as coal or textiles. They serve as a bridge and a link between government and enterprises, as has been confirmed in many sectoral plans. In addition, respective industry associations have been given the tasks of reflecting enterprises' concerns, guiding enterprises' behaviour, identifying potential issues impacting implementation of plans, and formulating corresponding policy suggestions (see also Chapter 4.3.3).

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[86] Law of the People's Republic of China on Public Servants (adopted by the NPC on 27 April 2005), http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384101.htm (accessed 24 November 2017).
[87] Communiqué of the Third Plenary Session of the 18th Central Committee of the CCP, http://www.china.org.cn/china/third_plenary_session/2014-01/15/content_31203056.htm (accessed on 10 October 2017).
[88] People's Daily. (2015). *New CCP regulation stresses role of leading Party members' groups*, http://en.people.cn/n/2015/0530/c90785-8899822.html (accessed on 23 August 2017).
[89] Such as the Ministry of Light Industry, Ministry of Textile Industry, etc.

In December 2016, the NDRC and the Ministry of Civil Affairs issued a circular with the stated purpose of making industry associations more independent from the government.[90] However, this does not mean that they are to be independent from Party influence. That same month, NDRC – together with other 9 ministries – issued the Measures for Comprehensive Supervision on Industry Associations and Chambers of Commerce.[91] These measures called for '*strengthening the Party's leadership, establishing and improving the party organisations in industry associations and chambers of commerce, and giving full play to the political core role of such Party organisations'*.[92] They also require that '*Party building requirements shall be written in the articles of association*'.[93]

3.4.4. JUDICIAL REVIEW

There is ambiguity with regard to the Chinese judicial system. On the one hand, Article 126 of the Constitution provides that *'the people's courts exercise judicial power independently in accordance with the provisions of the law, and are not subject to interference from any administrative organ, public organisation or individual'*. This is further reaffirmed by Article 8 of the People's Republic of China Judges Law ('Judges Law') which imposes *'no interference from administrative organs, public organisations or individuals*'. On the other hand, however, Article 7 of the Judges Law envisages that the obligation of the judges is among others '*to safeguard the State interests and public interests'*, Article 9 lists *'fine political and professional quality*' (emphasis added) as the necessary qualification of a judge and Article 30 sets out rewards for judges *'having performed outstanding deeds in safeguarding the interests of the State*'.

According to Article 11 of the Judges Law, presidents of courts are appointed by the NPC or the local People's Congress at various levels, and other judicial appointments are approved by the standing committees of the People's Congresses at the corresponding levels.[94] However, in practice the leadership of courts must at all levels be nominated by the respective CCP committees. When it comes to litigation, politically or economically sensitive cases may be decided behind the scenes by a judicial committee, in consultation with the Party and administrative offices.[95]

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[90] *China's industry associations to become more independent*, 29 December 2016, http://english.gov.cn/state_council/ministries/2016/12/29/content_281475527923580.htm (Accessed on 12 October 2017)
[91] Measures for Comprehensive Supervision on Industry Associations and Chambers of Commerce, National Development and Reform Commission, Ministry of Civil Affairs et. al., 19 December 2016, available at: http://www.gov.cn/xinwen/2016-12/29/content_5154008.htm (accessed on 16 October 2017).
[92] Ibid. Part 1.
[93] Ibid. Article 29.
[94] Although the majority of People's Congress are members of CCP, a small portion are not. In particular, Article 29 of the Electoral Law of the NPC and Local People's Congress provides that '*Each party or people's organization may jointly or individually recommend deputy candidates*.'
[95] Liebman, B.L. (2015). Legal Reform: China's Law-Stability Paradox, *Daedalus* 143, p.104.

The CCP furthermore controls the judiciary through Commissions of political and legal affairs at all levels of the CCP hierarchy.[96] Commissions for political and legal affairs at various levels of the Party play a key role in the Chinese system of justice. They exercise political oversight over the police, the courts, and the offices of the public prosecutors. These commissions instruct courts on certain judicial policies, but may also issue instructions on the judicial outcomes of specific cases.[97] They are regarded as staff organs of the Party committees.[98]

The rule of law is increasingly mentioned in Chinese public discourse, and was the focus of the 4th Plenum of the 18th CCP Central Committee in 2014. However, in Chinese legal tradition, the concept of rule of law differs from that of Western legal systems in that law has been regarded as an instrument to guide and control. The Chinese characters for 'rule of law' are often translated as 'rule by law'.[99] The 4th Plenum official communiqué affirmed the core role of the CCP and even went as far as to state that the leadership of the CCP and the socialist rule of law are identical:[100]

> *Implementing Party leadership in the entire process and all aspects of ruling the country according to the law is a fundamental experience of our country's Socialist rule of law construction. Our country's Constitution has established the leading position of the Chinese Communist Party. Persisting in the leadership of the party is a fundamental requirement for Socialist rule of law, […]. The leadership of the Party and Socialist rule of law are identical, Socialist rule of law must persist in the leadership of the Party, the leadership of the Party must rely on Socialist rule of law.*

Thus, while the 4th Plenum of the 18th CCP Central Committee in 2014 set the stage for judicial reforms, the reforms undertaken since 2013 do not mean that the CCP has in any way relinquished control of the constituent personnel of the judicial apparatus or its political oversight of the judiciary.

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[96] Heilmann, S. Shih, L., Rudolf, M. (2017), in Heilmann, S. (Ed.) (2017). *China's Political System.* Lanham, Maryland: Rowman & Littlefield, p. 138.
[97] Li, L. (2016). *The Chinese Communist Party and People's Courts: Judicial Dependence in China*, American Journal of Comparative Law, p. 59.
[98] Heilmann, S., Shih, L., Rudolf, M. (2017). in Heilmann, S. (Ed.) (2017). *China's Political System.* Lanham, Maryland: Rowman & Littlefield, p. 138.
[99] Chen, G. (2017). Le Droit, C'est Moi: Xi Jinping's New Rule-By-Law Approach, in *Oxford Human Rights Hub*, p. 1.
[100] Communique of the 4th Plenary Session of the 18th Central Committee of CPC, http://www.china.org.cn/china/fourth_plenary_session/2014-12/02/content_34208801.htm (accessed on 13 October 2017)

The links between the Party and the judiciary are also present through Party membership of the lawyers. In 2014 out of 270 000 licensed lawyers in China some 74 000 were Party members.[101]

The direct statement of the President of the Supreme People's Court ('SPC'), Xiao Yang, in 2008 confirmed the role of the party in the legal system: '*The power of the courts to adjudicate independently doesn't mean at all independence from the Party. It is the opposite, the embodiment of a high degree of responsibility vis-a-vis Party undertakings*.'[102]

This remains true today. A 2015 statement by Zhou Qiang, the President of the Supreme People's Court, displayed on the official website of the Supreme People's Court requires that:

> *All Courts shall use the spirit of Xi Jinping's series of major speeches to arm their minds, guide their practice, foster their work, shall keep strengthening teambuilding, shall foster the creation of teams that are loyal to the Party, loyal to the State, loyal to the People, loyal to the Law, shall earnestly fulfil the historical mission of People's Courts to build a moderately prosperous society, to deepen reform everywhere, to ensure the country is ruled in accordance with the law, ensure the strictly the Party's rule everywhere.*[103]

The article goes further instructing that:

> *All courts shall: deepen and foster the ideological and political construction; consider the study and implementation of the spirit of General Secretary Xi Jinping's major speeches as a major task; deepen the understanding of the speeches' core messages and spiritual essence; deepen the understanding of the many references to concepts of dialectical materialism and historical materialism included in the speeches; make sure that they duly reach brains and hearts, that they are used in faithfulness to the letter and that they are known and implemented; (…); consider the respect of discipline and rules as having a still more prominent position; strictly abide by the Party's discipline, organisation's discipline, political rules; resolutely preserve the Party's central authority.*[104]

In 2017, Zhou Qiang, still President of the Supreme People's Court, stated that '*China's courts must firmly resist the Western idea of judicial independence and other ideologies that threaten the leadership of the ruling Communist Party'*. Furthermore, *'courts in China are not independent and ultimately answer to the party leadership' and 'People's Courts at all levels*

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[101] Xinhua. (2015). Licensed lawyers surpass 271,000 in China, 08.04.2015, http://www.chinadaily.com.cn/china/2015-04/08/content_20032008.htm (accessed on 23 August 2017).
[102] Quoted by Fairbairn, W. (2016). An examination of judicial independence in China, *Journal of Financial Crime*, Vol. 23 Issue: 4, pp. 819-832, https://doi.org/10.1108/JFC-12-2015-0068 (accessed on 23 August 2017).
[103] Zhou Qiang: Fostering Courts that are loyal to the Party, loyal to the State, local to the People and loyal to the Law, 周强：培养造就忠于党忠于国家忠于人民忠于法律的法院队伍, 05.02.2015 http://www.court.gov.cn/zixun-xiangqing-13285.html (accessed on 16 October 2017).
[104] Ibid.

must disregard erroneous Western notions, including constitutional democracy and separation of powers'.[105] The Court's official publicity department reaffirmed those views by stating that creating a legal system independent of the party *'clearly violates the constitution'*, which says administrative, trial and prosecution authorities are all subservient to the National People's Congress, China's Parliament.[106]

3.5. THE CCP IN POLICY AND PLANNING

Any significant policy initiative will have been kicked off or at least been approved by the CCP. As explained in more detail in Chapter 4 (the system of plans), the CCP exercises significant power over the country's comprehensive and in depth economic planning system. This is for instance confirmed in the 13th FYP. The CCP plays a leading role in the preparation of the FYPs and is empowered to issue the full proposals for the FYPs,[107] even though they are formally approved by the NPC.

In its introductory paragraph, the 13th FYP explicitly refers to recommendations from the CCP as the basis for the plan:

> *Formulated on the basis of the Recommendations of the Central Committee of the Communist Party of China (CPC) for the 13th Five-Year Plan for Economic and Social Development of the People's Republic of China (2016–2020), the 13th Five-Year Plan sets forth China's strategic intentions and defines its major objectives, tasks, and measures for economic and social development. This plan is to serve as a guide to action for market entities, an important basis for government in performing its duties, and a common vision to be shared among the people of China.*

In Chapter 2 of the 13th FYP, the leading role of the CCP is expressly reaffirmed in the following paragraph entitled *Uphold leadership by the CCP*:

> *The Party's leadership is the greatest strength of socialism with Chinese characteristics, and provides the fundamental political guarantee for sustained, healthy economic and social development. We need to implement the requirements related to comprehensively strengthening Party self-governance, continuously strengthen the Party's creativity, cohesiveness, and dynamism, and continuously improve its capacity for and performance in governance so as to ensure the best*

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[105] Reuters. (2017). China's top judge warns courts on judicial independence, 16.01.2017, http://www.reuters.com/article/us-china-policy-law-idUSKBN1500OF (accessed on 23 August 2017).
[106] Ibid. Furthermore, according to Art 128 of the Constitution: *The Supreme People's Court is responsible to the National People's Congress and its Standing Committee. Local people's courts at various levels are responsible to the organs of state power which created them.*
[107] Xinhua. (2015). *China unveils proposals for formulating 13th five-year plan,* http://news.xinhuanet.com/english/2015-11/03/c_134780050.htm (accessed on 24 November 2017).

course of navigation for our country's development as it presses ahead through the waves.

Under Part XX of the 13th FYP, the CCP is also envisaged to take a leading role in the implementation of the 13th FYP:

In order to guarantee effective implementation of the 13th Five-Year Plan, we will, under the leadership of the CCP, ensure that governments at all levels better perform their duties and to the greatest possible extent stimulate the vitality and creativity of different types of participants, so that the entire Party and the people of China work together in finishing the building of a moderately prosperous society in all respects.

The leading role of the CCP is furthermore clearly indicated in more specific FYPs, such as the Foreign Trade Development 13th FYP, in which it is stated under Section 5, *Strengthen the organisational leadership and work security mechanism*:

Strengthen the CCP's leadership over foreign trade work. Highlight the core leading role of Party committees at all levels of the commerce system […] Implement the main responsibility of strict Party governance, improve long-term mechanisms to improve the probity and strengthen its power restraint and supervision. Strengthen the overall function of grassroots CCP organisations in the field of foreign trade, exert the fighting force vanguard function and CCP exemplary role to better promote the development of foreign trade.

An important vehicle of planning and policy leadership by the CCP is the Leading Small Groups, provided for under Chapter IX of the CCP Constitution. They are becoming increasingly important in the Chinese system. In effect, decision-making powers with respect to institutional restructuring of the State and the economy are now concentrated in Central Leading Small Groups. While these groups have existed since the 1950s, they are currently taking an unprecedented role in that they help define problems, set priorities, and determine the proper sequencing of policies across a wide range of areas. They are also set up under the CCP Constitution rather than state laws. For example, the Leading Small Group for Comprehensively Deepening Reforms, established in the context of the 3rd Plenum Decision (see Chapter 5.3) and responsible for developing policy guidelines for reforming the economic, political, cultural, social, ethical and party-building systems in order to address long-term reform issues, as well as to guide reform-related bodies of the CCP at central and local level, and supervise the implementation of reform plans, is led by Xi Jinping himself.[108]

[108] For further information on linkages between state and Party leaders, as well as Small Leading Groups, see Batke. J and Stepan, M. (2017). *Party, State and Individual Leaders. The Who's Who of China's Leading Small Groups.* Mercator Institute for China Studies. Available at: https://www.merics.org/en/merics-analysis/china-mapping/the-whos-who-of-chinas-leading-small-groups/ (accessed on 17 August 2017).

3.6. CHAPTER SUMMARY

The CCP is the only governing party in China, with its leadership role assigned by China's Constitution. This leadership role covers all aspects of the State (government, armed forces etc.) but also – and this is important for the purposes of this report - the economy and the judicial system. Countless laws, official documents, and statements confirm this. In order to exercise this leadership, the CCP has a comprehensive toolbox at its disposal, which includes:

- a high overlap between senior government positions and party membership;
- a tight control over nominations of senior positions in all emanations of the State including top managers of SOEs (who in some cases also have ministerial rank) and the judiciary;
- the wide-spread existence of party organisations within individual companies and businesses. The CCP's central inspection system has recently been strengthened and explicitly also covers enterprises, including both SOEs and private companies. Recently, the CCP has been tightening its control over economic operators by insisting on the party organisations playing increasingly important roles in the decision making within companies. It has also been widely reported that the role of the CCP – enshrined in law already – is now also to be formalized in the articles of associations of selected companies;
- so-called leading Party Members' groups whose work also covers industrial matters;
- the deep involvement of the CCP in the planning process of the economy and industry as well as in the implementation of such plans which, as described in Chapter 3, is unique to China given its comprehensiveness and the level of detail.

In short, the CCP sets the economic agenda and controls all aspects of its implementation. This competence of the CCP goes far beyond a macroeconomic control. Indeed, it extends to the level of business decisions of individual enterprises, both SOEs and – at times – privately owned companies. This in turn means that business decisions are very much influenced by the various public policy objectives pursued by the State and the CCP.

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4.1. INTRODUCTION

When China introduced its first FYP, it set out on a course of social and economic development strategies to drive growth every five years. China's 1st FYP which covered the period from 1953 – 1957 started the practice of planning and implementing successive FYPs, the latest adopted in March 2016. The first plan was largely modelled on the system of economic planning which was followed by the Soviet Union since 1928. The central objectives of the 1st Chinese FYP were the nationalisation and rapid development of the industrial sector (in particular iron and steel, electric power, coal, heavy engineering, building materials, and basic chemicals) as well as the collectivisation of agriculture.

Some sixty years later and with the 13th FYP in place, many aspects of the planning system in China have evolved and changed. While the earlier FYPs were characterised by prescribing

very specific targets to achieve the given set of objectives, this has been largely replaced by guideline-like goals[109] in the recent plans,[110] starting with the 11th FYP.[111]

Even since the release of the 11th FYP, the substance of the plans has seen significant developments. The structure of the plans grows in complexity and emphasis may shift to values which previously were not part of the planning or which were less in the focus of the Chinese authorities. This can be illustrated by comparing the respective sections dedicated to environment and resources in the 12th and 13th FYP[112] or by the inclusion of a number of new targets related to science and technology in the 13th FYP.[113]

However, such gradual developments do not alter the nature of the plans. Being more than just strategic visions, they determine the direction of the Chinese economy, set out priorities and prescribe the goals which the central and local governments must focus on and strive to implement. This is understood both by authorities at the corresponding levels of government as well as by enterprises. Therefore, the plans maintain their distinctive impact on the economy.

4.2. System of Plans

4.2.1. Structure of the Chinese planning system

The Chinese system of plans forms a matrix encompassing virtually all economic activity in the country, as well as other areas, such as social welfare or environmental protection. In 2005 in the State's Council Several Opinions on strengthening Drafting Work for the National Economic and Social Development Plan, the Chinese government provided a 'three-by-three' system according to which the plans are organised. Vertically they are divided into national, provincial and municipal/county plans and then by function into comprehensive, macro-regional and specialized plans.[114] At the top of the entire system sits the central national plan (currently the 13th FYP for National and Social Development), as well as some overarching strategies, such as the China Manufacturing 2025 plan ('Made in China 2025', see section 4.2.3), the Belt and Road Initiative ('BRI', also referred to as 'One Belt One Road' or 'OBOR'), (see section 4.2.4), the so called Supply-Side Structural Reforms ('SSSR', see section 4.2.5) and other medium and long-term strategic plans. With reference to the central FYP and the overarching strategies, hundreds[115] of additional plans are issued at various levels of government and at various points in time, forming eventually a matrix-like structure

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[109] Which distinguish between 'predictive' and 'mandatory' targets.
[110] At least on the higher levels of state planning (see below in sections 4.2.7 and 4.2.8).
[111] See Melton, O. (2015). *China's Five-Year Planning System: Implications for the Reform Agenda, Testimony for the U.S.-China Economic and Security Review Commission*, p. 5.
[112] See Chapter 42-48 of the 13th FYP and chapters 21-26 of the 12th FYP.
[113] See Chapter 3: Main objectives of the 13th FYP.
[114] See Section 1.1 'Several Opinions on strengthening Drafting Work for the National Economic and Social Development Plan – Issued by State Council 22 October 2005.
[115] See Kennedy, S. (2016). Impressions of the 13th FYP Proposal. in: *State and Market in Contemporary China*, CSIS, p. 51.

in which the subsequent / lower level plans further detail the pre-existing / higher level ones, are aligned with them[116] and implement them (see sections 4.3.1 and 4.3.2).

On the horizontal plane, the central FYP and the broader strategies are referenced in sectoral plans prepared by individual line ministries and other central authorities. Table 1 below gives an overview of the system of plans, including a listing of a number of sectoral plans which have been adopted following the adoption of the 13th FYP. While this list is only illustrative (as mentioned above, planning covers virtually every economic activity with plans in place in the areas such as tourism, food, health and wellness etc.) and in any event limited to the top layer within the structure of plans, it demonstrates the extent of the Chinese planning system. Note also that this list is not exhaustive even as far as sectoral plans are concerned.

Table 1: Illustrative list of China's Planning System[117]

Overarching Strategies
Made in China 2025
BRI
SSSR
Internet +
FYPs
National FYP
13th FYP for National and Social Development
Sectoral Plans
Industry (sectors)
Information Industry Development Guide
Advanced Manufacturing Technology Innovation Plan
Light Industry Development Plan
Software and Information Technology Services Development Plan
Information and Telecommunications Industry Development Plan
Steel Adjustment and Upgrading Plan
Textile Industry Development Plan
Construction Industry Plan
Building Material Industry Development Plan
Petrochemical and Chemical Industry Development Plan
Pharmaceutical Industry Development Guide
Civil Explosive Products Industry Development Plan

[116] One of the mechanisms to ensure consistency in the planning process is reviewing of lower administrative levels' draft plans of by higher level government bodies before adoption. See Taube, M. and Schmidkonz, C., (2015). *Assessment of the normative and policy framework governing the Chinese economy and its impact on international competition.* Think!Desk,, p. 42.

[117] The full text of the plans is available on the websites of the respective authorities which have issued the plans, typically the State Council, the NDRC, the relevant line ministries (such as MIIT, MoF, MoA) or other agencies (e.g. NEA).

National Mineral Resources Plan
Non-Ferrous Metal Industry Development Plan
Shipping Industry Structure Adjustment and Transformation and Upgrade Action Plan
Chemical Fibre Industry Development Guide
Made in China 2025 Agricultural Machinery
Guide for the development of the new materials industry
Industry (issues)
Foreign Trade Development 13th 5 year plan
Smart Manufacturing Development Plan
National Strategic and Newly Emerging Industries Development Plan
Industry Green Development Plan
Big Data Industry Development Plan
State Radio Management Plan
Rare Earth Industry Development Plan
Robotics Industry Development Plan
Industrial Technology Innovation Plan
Information and Industry Integration Plan
Promoting the Development of Small and Medium-Sized Enterprises (SMEs) Plan
Five-Year Action Plan to Promote the Internationalization of Small and Medium-Sized Enterprises
New Materials Industry Development Guide
National Standard System Building Development Plan
Smart Health Elderly Caring Industrial Development Action Plan
Agricultural Machinery Equipment Development Action Plan
Energy
Shale Gas Development Plan
Natural Gas Development Plan
Oil Development Plan
Plan on Petroleum and Gas
Renewable Energy Development Plan
Solar Energy Development Plan
Electric Power Development Plan
Wind Power Development Plan
Energy Development Plan
Energy Technology Innovation Plan
Nuclear Industry Plan
Coal Industry Development Plan
Geothermal Energy Exploration and Usage Plan
Energy Conservation and Environmental Protection Industry Development Plan
Biomass Energy Development Plan

Rural Biogas Development Plan
Science and Technology
National Science and Technology Innovation Plan
National Basic Research Plan
National Informatisation Plan
Surveying and Geographical Information Cause Plan
Protection and Use of Intellectual Property Plan
Transportation
Transportation Science and Technology Development Plan
Transportation Informatisation Development Plan

The system is not strictly segmented along a fixed classification of industries/sectors.[118] Rather, the plans for specific sectors (e.g. steel, textile of chemical) are complemented by plans which reflect the broader priorities of the leadership in a given planning period. Such priorities (e.g. '*smart manufacturing*', '*green development*', '*cyber economy*' or '*opening-up*' which in the language of the plans refers to internationalisation)[119] are in turn interlinked with additional objectives proclaimed by the government.

The emphasis on strategic emerging industries is one of these additional objectives. It is present in Chinese policy making since at least 2010 and has evolved gradually as the government keeps issuing new iterations of the Strategic Emerging Industries Key Product and Services Catalogue.[120] Currently it covers eight sectors - next generation information technology, high-end equipment manufacturing, new materials, biotechnology, new-energy vehicles, new energy, energy efficient and environmental technologies, as well as digital innovation - and a ninth category covering related services. Those priorities and objectives are respected when the central government guidance is translated into policies at lower levels of administration (e.g. see under section 4.2.9: specific projects developed in Hebei province for Strategic Emerging Industries).

This applies also to strategic objectives of the central government stemming from the overarching initiatives which exceed the usual system of plans. The entire system of planning (which in itself does not form a fixed structure but rather a constantly developing area of policy making, subject to permanent reviews and adjustments) must be therefore understood as embedded in the wider context of the Chinese policy – and decision-making which in turn feeds back into the planning process. Sub-plans, at the sectoral or provincial level are drawn

[118] Taube, M. and Schmidkonz, C. (2015). *Assessment of the normative and policy framework governing the Chinese economy and its impact on international competition.* Think!Desk,, p. 35-36.
[119] See e.g. Parts V,VI, IX and X of the 13th FYP.
[120] Full Catalogue: http://www.ndrc.gov.cn/gzdt/201702/W020170204632980447904.pdf (accessed on 11 August 2017) The current revised edition was published in February 2017 by NDRC together with the Ministries of Science and Technology, Industry and Information Technology, and Finance. The eight/nine strategic emerging industries are further divided into 174 subcategories and 4 000 more detailed products and services.

up in reference to the national plan to ensure consistency and elaborated in accordance with the objectives of the national plan.[121]

The provincial Plans for Social and Economic Development and plans issued by lower level governmental authorities can be found on the vertical axis of the planning matrix. Table 2 below contains a list of provincial plans adopted under the 13th FYP, as well as some examples of municipal plans.

Table 2: Plans for provinces and provincial-level municipalities and autonomous regions adopted in connection with the 13th FYP[122]

Provincial 13th FYPs
Anhui Economic and Social Development
Beijing Economic and Social Development
Chongqing Economic and Social Development
Fujian Economic and Social Development
Gansu Economic and Social Development
Guangdong Economic and Social Development
Guangxi Zhuang Autonomous Region Economic and Social Development
Guizhou Economic and Social Development
Hainan Economic and Social Development
Hebei Economic and Social Development
Heilongjiang Economic and Social Development
Henan Economic and Social Development
Hubei Economic and Social Development
Hunan Economic and Social Development
Inner Mongolia Autonomous Region Economic and Social Development
Jiangsu Economic and Social Development
Jiangxi Economic and Social Development
Jilin Economic and Social Development
Liaoning Economic and Social Development
Ningxia Hui Autonomous Region Economic and Social Development
Qinghai Economic and Social Development
Shaanxi Economic and Social Development
Shandong Economic and Social Development
Shanghai Economic and Social Development
Shanxi Economic and Social Development
Sichuan Economic and Social Development
Tianjin Economic and Social Development

[121] Kennedy, S. and Johnson, K. (2016). *Perfecting China, Inc. The 13th Five-Year Plan*. Washington, DC: CSIS, p. 13-14.

[122] The full text of the plans is available on the websites of the respective authorities which have issued the plans, typically the provincial governments.

Tibet Autonomous Region Economic and Social Development
Xinjiang Autonomous Region Economic and Social Development
Yunnan Economic and Social Development
Zhejiang Economic and Social Development

Each such provincial-level plan is further detailed by respective sectoral plans issued by individual provinces. To give an example, Table 3 below contains a non-exhaustive list of sectoral plans of Hebei Province and the Guangdong Province.

Table 3: Selected sectoral plans of the Hebei and Guangdong provinces adopted in connection with the 13th FYP[123]

Hebei Province – selected 13th FYPs
Petrochemical industry development plan
Strategic emerging industry development plan
Coal industry development plan
Natural gas development plan
Rail transit development plan
Equipment manufacturing industry plan
Modern agriculture development plan
Renewable energy development plan
Energy saving plan
Industrial transformation and upgrading plan
Utilizing foreign and overseas investment plan
Development plan of private economy
Water conservancy development plan
Safe production plan
Housing and urban construction plan
Rural power grid transformation and upgrading plan
Development plan of forestry
Postal industry development plan
Development of cultural industry plan
Basic surveying and mapping plan
Brand name and service brand cultivation plan
Press and publication of radio and television development plan
Meteorological development plan
Development of civil administration plan
Marine economy development plan

[123] The full text of the plans is available on the websites of the Hebei and Guangdong authorities, such as the Hebei Province Development and Reform Commission (http://www.hbdrc.gov.cn/web/web/index.htm, accessed on 8 August 2017) or the Guangdong Province Development and Reform Commission (http://210.76.72.13:9000/pub/gdsfgw2014/, accessed on 8 August 2017).

Marine environment protection plan
Health and health planning plan
Human resources and social security career development plan
Easy to relocate poverty alleviation plan
Guangdong Province – selected 13th FYPs and additional plans
Energy development plan
Development of advance manufacturing plan
Development of open economy plan
Innovation development plan
Comprehensive communications and transport system plan
Development of a modern service sector plan
Development of marine economy plan
Development of a modern agriculture plan
Water conservancy plan
Modernisation of market surveillance and management plan
Energy saving and emissions reduction plan
Establishment of urban infrastructures plan
Plan on speeding up the establishment of an advanced province as regards innovation-driven development
Plan on the development of smart manufacturing (2015-2025)
Action plan on 'internet plus' (2015-2020)
Plan on a new model of urban development (2014-2020)
Food and drug safety plan
Food security plan
Plan on development of East-Guangdong's ports cluster (2016-2030)

Plans are also issued by the lower administrative levels, such as counties and municipalities. In the case of Hebei, the Table 4 below lists a number of these plans:

Table 4: Selected municipal plans of the Hebei province adopted in connection with the 13th FYP[124]

Hebei Province Municipal 13th FYPs
National economic and social development plan Shijiazhuang City
National economic and social development plan Tangshan City
National economic and social development plan Handan City
National economic and social development plan Quinhuangdao City
National economic and social development plan Baoding City
National economic and social development plan Xingtai City
National economic and social development plan Chengde City

[124] The full text of the plans is available on the websites of the respective municipal authorities.

National economic and social development plan Cangzhou City
National economic and social development plan Langfang City
National economic and social development plan Dingzhou City
National economic and social development plan Hengshui City
National economic and social development plan Xinji City

In addition, individual FYP are also issued by entities which do not belong to the inner circle of government bodies such as state-run research institutes[125] or SOEs.[126]

To provide an example, the state-owned China National Petroleum Corporation (CNPC, China's largest energy company) has published a report on its website that outlines not only the company's FYP content but also sheds some light on the drafting process. The company has assembled a so-called leading small group (for more details on leading small groups, see Chapter 3.5) staffed with senior managers that has spent two years on preparing the plan. CNPC claims to have:

> *firmly oriented its 13th FYP to fully implement the spirit of the third, fourth and fifth plenary sessions of the 18th CPC central Committee, thoroughly implement the spirit of the series of important speeches given by CPC General Secretary Xi Jinping, adhere to the "four comprehensive" strategic layout and the "energy revolution" strategic thinking. Establish the concept of innovative, coordinated, green, open and shared development, elaborate the strategic intention of the group during the "13th Five-Year Plan" period, and clearly put forward the creation of a world-class integrated international energy company in two steps.*[127]

Similarly, the state-owned China Nonferrous Metals Co. Ningxia Oriental Group Co., Ltd. (CNMNC) provides on its website[128] a concise outline of its FYP. The document defines targets for sales income, profit, gross value added and other indicators for 2015 and 2020[129]

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[125] For an explanation of the role of research institute in the Chinese government system, see Lawrence, S.W. and Martin, M.F. (2013). *Understanding China's Political System.* Congressional Research Service, p. 36): '*Many are affiliated either with an official agency, such as the Ministry of State Security's China Institutes for Contemporary International Relations* […], *or with universities. Such centres make their influence felt in the policy process in part by accepting commissions from the Party or state to write reports on policy issues, and by self-generating reports that they submit to policymakers. Experts attached to the institutes also often serve as formal and informal advisors to official bodies* […]'.

[126] For instance, the SINOPEC FYP was published in July 2016 (see http://www.sinopecnews.com.cn/news/content/2016-08/03/content_1634535.shtml, accessed on 28 July 2017).

[127] See 中国石油集团发布"十三五"发展规划 available at: http://news.cnpc.com.cn/system/2016/04/26/001589910.shtml, accessed on 11 August 2017.

[128] 绘制未来十年集团公司发展新蓝图集团公司十二五发展 http://www.cnmnc.com/index.php?m=content&c=index&a=show&catid=13&id=779

[129] The company's FYP also calls for '*promoting the pace of new industry construction, the development of unique competitive advantages and leapfrog development*'. It also pledges '*efforts to promote technological progress,* […] *improve staff income, promote the building of a harmonious enterprise, and strengthen Party building work*'. The CNMNC's FYP further announces that '*the company will speed up the adjustment of the product portfolio, while steadily increasing the market share of the traditional leading products, while accelerating the titanium and titanium alloys, capacitors, micro-alloy steel charge, beryllium copper processing*

(regarding the substance of FYPs, see in particular sections 4.2.2 and 4.2.8). However, issuing FYPs on the company level is not limited to SOEs but extends to privately owned businesses, many of which would prepare their own plans as well.[130]

Finally, the structure of plans is complemented by thousands of sub-plans, implementation programs, circulars, notices etc.[131] which will typically set up procedures to effectively deploy the relevant resources.[132]

4.2.2. SUBSTANCE OF THE PLANS

As for substance of individual plans, the level of detail in terms of policy objectives, output targets etc. tends to increase as the administrative level at which the respective plan was issued decreases. The national FYP covers a vast array of topics which in the case of the 13th FYP ranges from economy, to culture, social welfare, environmental protection or issues of national defence and may therefore need to remain limited to setting broad overall priorities. Similarly, the overarching strategies may be more specific in some aspects (e.g. Made in China 2025 only focuses on manufacturing industry) but will be formulated in a rather general manner for other reasons, such as their longer time horizon (Made in China 2025) or their cross-cutting nature (SSSR). However, the planning system taken in its entirety – covering all levels of government with an ever growing precision concerning actions to be taken – sets China apart from mere programmatic declarations outlining the government's policies and priorities seen in other countries. While such programmatic declarations provide political legitimacy for the government's actions and ensure its accountability, the Chinese system of planning is geared towards allowing and directing manifold government interventions into the economy. Even though the section on guiding principles[133] in the 13th FYP does refer to the economic reforms which are supposed to also entail a stronger role

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materials, tantalum and niobium processing materials, chemical and fine chemicals'. In addition, in line with policies contained in the national and higher administrative level FYPs, the CNMNC plan envisages '*efforts to develop and expand along the industrial value chain,* […] *develop the circular economy; implement a vertical integration strategy, upgrade from basic processing to deep processing of goods*'. And further: '*On the one hand, the company will focus on tantalum, niobium and beryllium as its main business* […]*; the company's status as one of the world's three leading tantalum enterprises and as China's sole beryllium processing base role must not be lost. On the other hand, we have to look at other relevant metals and industries, rely on independent innovation, develop own intellectual property rights, and possess advanced levels of core technologies and growth points; strengthen the industrial and export innovation base, the tantalum and niobium engineering centre and other technological innovation platforms,* […] *and vigorously improve the ability to attract, digest, absorb and re-innovate.*'

[130] See for example here concerning the FYP of the privately owned manufacturer of automotive starter acid lead batteries Camel Group Co., Ltd.: http://www.hj.cn/html/201512/30/3069457412.shtml, accessed on 11 August 2017.

[131] See Melton, O. (2016). China's Five-Year Planning System: Structure and Significance of the 13th FYP, in: S. Kennedy, (editor) (2016). *State and Market in Contemporary China*, CSIS, p. 42).

[132] See Melton, O. (2015) *China's Five-Year Planning System: Implications for the Reform Agenda, Testimony for the U.S.-China Economic and Security Review Commission Hearing on "China Ahead of the 13th Five-Year Plan: Competitiveness and Market Reform", Washington, D.C.* p. 3 and Taube, M. and Schmidkonz, C. (2015). *Assessment of the normative and policy framework governing the Chinese economy and its impact on international competition.* Think!Desk, p. 42.

[133] These principles are in one or another form part of all the related FYPs at the lower levels of administration.

of market forces ('*in line with the chief objectives of improving and developing socialism with Chinese characteristics and modernizing the country's governance system and capacity for governance, we need to improve the systems by which the market plays the decisive role in resource allocation and the government plays a more effective role*')[134] it only does so in the broader context of the socialist market economy (see Chapter 2) under the CCP rule (see Chapter 3):

> *The period covered by the 13th Five-Year Plan will be decisive for finishing building a moderately prosperous society in all respects. We must implement the strategic plans and policies of the CPC Central Committee, achieve an accurate understanding of profound changes in domestic and international environments and circumstances faced by China in its development efforts, proactively adapt to, understand, and guide the new normal in economic development, and comprehensively advance innovative, coordinated, green, open, and shared development so as to ensure that a moderately prosperous society is established in all respects.*[135]

Within the Chinese coordinated planning system, the form which specific government interventions will take, follows the general rule of the higher level plans setting broad outlines and overall targets, whereas the more practical aspects of how the centrally set goals should be achieved are specified in the plans at the lower levels. This central feature of the planning system, where initial broadly drawn guidelines gradually seep down the government structure and eventually take the shape of individual administrative measures on resource allocation, can be illustrated in the existing structure of the overarching initiatives and the central 13th FYP, which in turn are translated into more specific targets and actions in the sectoral provincial plans. The coherence in the lower levels of the planning is encouraged in the guidelines issued by the General Office of the CPC Central Committee and the General Office of the State Council in October 2016, Opinion on Setting up and Completing a Mechanism for the Implementation of the National 13th Five-Year-Plan'.[136]

4.2.3. MADE IN CHINA 2025

Made in China 2025 is a comprehensive long-term programme focused on manufacturing, with the main goal to shift Chinese manufacturing upwards to higher value-added manufacturing, emphasizing in particular the use of innovative manufacturing technologies. It targets ten sectors for which strategic tasks and goals are specified and the related government support measures laid down:

- advanced IT
- aerospace and aeronautics
- agricultural equipment

[134] See Chapter 2 of the 13th FYP.
[135] See Part I, Introduction to the 13th FYP.
[136] Full text available at: http://www.gov.cn/zhengce/2016-10/23/content_5123382.htm

- automated machines and robotics
- biopharma and medical products
- maritime equipment and shipping
- new-energy vehicles and equipment
- new materials
- power equipment
- rail transport equipment. [137]

Made in China 2025 envisages three steps for the development of Chinese manufacturing. The first step aims to '*turn China into a major manufacturing power in ten years'*, the second step which should be implemented between 2025 and 2035 aims at China reaching '*intermediate level among world manufacturing powers*',[138] and in the third step, ending in 2049, China is supposed to achieve a more consolidated manufacturing sector which will allow China to '*transform* [itself] *into the global manufacturing leader before the centennial of the founding of New China'*.[139] To achieve the goal of becoming a global manufacturing leader, China is supposed to '*strengthen overall planning, ensure innovation-driven breakthroughs, set out specific policies, make the most of the system's advantages, mobilise all the society's forces to work hard, rely still more on domestic equipment, rely on domestic brands'*.[140] *(emphasis added)*

China is pursuing a policy of favouring those industries. As an example of practical implications for the New Materials industry, see Chapter 12.3.2.

The government support to achieve the overall goals includes a number of measures, in particular financial support policies:

> *We will*
> *• deepen financial reform by widening manufacturing financing channels and reducing financing costs,* […]
> *• support Export--Import Bank of China to strengthen services for manufacturing "going out" within its scope of business,*
> *• encourage the China Development Bank to increase loans for manufacturing Enterprises,*
> *• lead financing institutions to develop products and business for manufacturing Enterprises,* […]
> *• lead venture capital and private equity to support manufacturing sector innovation.*[141]

[137] Many of them overlap with the 2010 Strategic Emerging Industries (see also section 4.2.1 above).
[138] See Made in China 2025, Section 2.3.
[139] That is before 2049 - see Overview section of Made in China 2025 (emphasis added). For intermediate steps to be achieved by 2020, 2035 and 2049, respectively, see section 2.3 of Made in China 2025.
[140] See Made in China 2025, Section 1.3.
[141] Ibid., Section 4.3.

Furthermore, there are fiscal and taxation policies listed in the document:

> *We will*
> *• make full use of present channels to strengthen financial support and the policy environment for manufacturing with a focus on key areas for manufacturing transformation, namely intelligent manufacturing,* […]
> *• innovate the support way of fiscal fund by transforming from subsidizing construction to subsidizing operation step by step and increase the effectiveness of financial fund,*
> *• deepen technology planning (special projects and funds), technology management reform, and manufacturing technology research and demonstration projects to support technology innovation and structural adjustment,*
> *• perfect and implement government purchasing policies supporting innovation* […].[142]

Made in China 2025 refers to deepening reforms and giving markets the decisive role in allocating resources,[143] as known from other contexts (see Chapter 5). However, the strategy remains top-down driven, entailing government action ('*we will strengthen planning*', '*we will encourage enterprises*', '*we will support enterprises*')[144] which would be carried out by using the above support measures. At the same time, the ultimate goal - namely for China to become one of the world's most advanced and competitive economies, with domestic firms being globally competitive, while gradually substituting foreign technology with local technology – also appears as not necessarily compatible with free play of market forces and, instead, requiring heavy government intervention in favour of domestic producers. The MIIT Guidelines on 2017 industrial upgrade (Made in China 2025) projects funding (departmental budget)[145] published August 2017 only confirm this by emphasizing that within the goal of fully implementing the Made in China 2025 strategy, '*funding* [will be] *allocated to projects that cannot get funding from the market and need central support*'.

4.2.4. BELT AND ROAD INITIATIVE

The BRI, initially floated by President Xi in autumn 2013, represents another strategic government programme, focusing primarily on infrastructure developing projects that would span a significant number of countries around the globe. On 28 March 2015, NDRC, Ministry of Foreign Affairs ('MFA'), and Ministry of Commerce ('MOFCOM'), with State Council authorization, issued the One Belt One Road Action Plan, which provides further details.[146]

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[142] Ibid., Section 4.4.
[143] Ibid., Section 2.2.
[144] Ibid., Part III. The mechanism of how the generally worded goals of the strategic initiatives are translated into more specific targets in plans on lower administrative levels is described further below, see in particular sections 4.2.9 and 4.2.10.
[145] Available at: http://xxgk.miit.gov.cn/gdnps/wjfbContent.jsp?id=5766699, accessed on 25 August 2017
[146] Full text available here: http://english.gov.cn/archive/publications/2015/03/30/content_281475080249035.htm, accessed on 8 August 2017.

While the Action Plan states that overall BRI '*aims to promote the connectivity of Asian, European and African continents and their adjacent seas'*, it leaves no doubt that the initiative is closely linked to China's strategy of internationalisation and becoming a global industrial leader: '*China will stay committed to the basic policy of opening-up, build a new pattern of all-around opening-up, and integrate itself deeper into the world economic system. The Initiative will enable China to further expand and deepen its opening-up*.'[147]

The Action Plan lists various cooperation modalities among participating countries.[148] However, it also contains a dedicated section on the role of China and its regions in the *BRI* context: '*China will fully leverage the comparative advantages of its various regions, adopt a proactive strategy of further opening-up, strengthen interaction and cooperation among the eastern, western and central regions, and comprehensively improve the openness of the Chinese economy.*'[149] It is in particular this section which fits into the scheme of the Chinese planning system, as it sets specific policy goals and priorities for individual areas. For example, with respect to the north and north-west regions, the Action Plan states that:

> […] we *should make good use of Xinjiang's geographic advantages and its role as a window of westward opening-up to deepen communication and cooperation with Central, South and West Asian countries, make it a key transportation, trade, logistics, culture, science and education centre* [and] *we should give full play to Inner Mongolia's proximity to Mongolia and Russia* […] *and advance the construction of an Eurasian high-speed transport corridor linking Beijing and Moscow with the goal of building key windows opening to the north*.[150]

Or, with respect to coastal regions:

> *We should use opening-up to motivate these areas to carry out deeper reform, create new systems and mechanisms of open economy, step up scientific and technological innovation, develop new advantages for participating in and leading international cooperation and competition, and become the pacesetter and main force in the BRI*.[151]

And concerning the inland regions:

> *We should build Chongqing into an important pivot for developing and opening up the western region, and make Chengdu, Zhengzhou, Wuhan, Changsha, Nanchang and Hefei leading areas of opening-up in the inland regions. […] We*

[147] See Action Plan, Part I.
[148] Such as facilities connectivity, unimpeded trade or financial integration.
[149] See Action Plan, Part VI.
[150] Ibid., Part VI.
[151] Ibid., Part VI.

should support inland cities such as Zhengzhou and Xi'an in building airports and international land ports.[152]

While Made in China 2025 lies outside the five year planning cycle due to its time horizon and focus on manufacturing industry, in the case of BRI, it is its international scale and focus on infrastructure which distinguishes it from the usual FYPs. At the same time, BRI forms part of the entire planning system, insofar as it contains the familiar features of the Chinese economic plans, in particular by putting emphasis on selected sectors or actions (including by envisaging support for such actions) which the local governments would need to take into account when setting their local policies via their respective plans.

It is important to note that the notion of 'opening-up' which is frequently referred to by the Chinese authorities in the BRI action plan, does not necessarily point primarily towards domestic reforms, e.g. improving the regulatory climate for foreign investment [153] or facilitating access to the Chinese market. The focus is rather on supporting the Chinese industry in expanding abroad, in line with the policy of creating a set of internationally competitive national champions (see section 5.5.1) and going global (see section 14.1.1). The language of the central 13th FYP – which contains a dedicated section on BRI – fully confirms this:

We will encourage more of China's equipment, technology, standards, and services to go global by engaging in international cooperation on production capacity and equipment manufacturing through overseas investment, project contracting, technology cooperation, equipment exporting, and other means, with a focus on industries such as steel, nonferrous metals, building materials, railways, electric power, chemical engineering, textiles, automobiles, communications, engineering machinery, aviation and aerospace, shipbuilding, and ocean engineering.[154]

And further:

[we] will develop outward-oriented industrial clusters and create centres of opening up with specialized areas of focus'[155] or '*we will improve the structure of foreign trade by promoting diversification in export markets and increasing the proportion of emerging markets while maintaining the share of traditional ones. We will encourage the development of new types of trade and work to develop export credit insurance. We will actively work to increase imports and improve the import structure by importing a greater amount of advanced technology, advanced equipment, and high quality consumer goods.*[156]

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[152] Ibid., Part VI.
[153] Even though also such language is present, see 13th FYP, Chapter 49, section 4.
[154] Ibid., Chapter 49, section 2.
[155] Ibid., Chapter 49, section 1.
[156] Ibid., Chapter 49, section 3.

4.2.5. SUPPLY SIDE AND STRUCTURAL REFORMS

The concept of Supply-Side Structural Reforms ('SSSR') was introduced by China's leadership in 2015 in an attempt to address concerns with respect to five broad issues: industrial overcapacity, housing inventory, corporate debt, corporate costs and position of Chinese producers in the industrial value chains. As such, SSSR represents a broad strategic industrial policy which, according to China's official news agency is '*at the core of China's economic work*'[157] and is considered by some[158] as having superseded the reform agenda under the 2013 3rd Plenum Decision (see Chapters 2.1.4 and 5.3).

While the document outlines such objectives as curbing overcapacity in the steel and coal sector, a more detailed view of the SSSR reveals that the reforms remain government driven (as opposed to allowing market forces to correct existing imbalances), limited in scope and missing the root causes of the problems identified. Typically, with respect to overcapacity, after the initial government push in 2016, the cuts envisaged for 2017 have been less ambitious. The cuts also remained focused mainly on private companies, largely ignoring the overcapacity issue with respect to SOEs, as cutting capacity in the SOE sector would likely interfere with other government policies (see Parts II and III). Most importantly, the overcapacity-related SSSR do not address the core problem of access to cheap credit and government guarantees which in turn result in persistence of inefficient production and proliferation of 'zombie' companies (see in particular Chapter 11.4.4and 14.4).[159] Similarly, the SSSR component aimed at boosting innovation (thereby moving the Chinese economy up the industrial value chains) appears for the time being to take the shape of government support for selecting industry sectors (e.g. those listed as priority in the context of Made in China 2025 (see Section 4.2.3)) rather than addressing the underlying problems of barriers to market access for new entrants, insufficient protection of intellectual property rights or inadequate education system.[160]

Given the importance that Chinese authorities, including President Xi,[161] attach to SSSR, as well as its implications for other (sectoral) industrial policies, SSSR represent one of the most important strategic economic programmes of the government. Even though still in its early stages, the SSSR-related government actions so far appear to result essentially in additional state interventions where the SSSR label will be used to set production/capacity targets, to provide financial support to selected industries etc. instead of merely setting out an

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[157] Xinhuanet. (2017). *President Xi stresses commitment to supply-side structural reform* http://news.xinhuanet.com/english/2017-07/27/c_136478067.htm (accessed on 28 August 2017)
[158] The Economist Intelligence Unit, (2017). *China's supply-side structural reforms: Progress and Outlook* http://www.eiu.com/public/thankyou_download.aspx?activity=download&campaignid=ChinaSSSR2017 (accessed on 28 August 2017), p. 3.
[159] Ibid., p. 5-9.
[160] Ibid., p. 23-28.
[161] See e.g. Xinhuanet. (2017). *Xi stresses commitment to supply-side structural reforms* http://news.xinhuanet.com/english/2017-07/27/c_136477827.htm (accessed on 29 August 2017)

appropriate regulatory framework within which market forces would be allowed to fully develop.[162]

4.2.6. INTERNET +

In July 2015, Premier Li Keqiang unveiled China's Internet Plus plan developed by the State Council. The purpose of the plan is to integrate the internet with traditional industries as a further means to drive economic growth, thereby supporting a key objective of the 13th FYP. The Internet Plus plan will support restructuring and upgrading of manufacturing industry through modernising and creating efficiencies across production processes. The plan must be seen as a key element in China's overall plans given that the importance of using information technology and the development of the internet as a tool for innovation and modernisation to drive growth, features high in the 13th FYP. In addition, Advanced IT is the first of ten sectors identified under Made in China 2025.

In launching the plan Premier Li Keqiang said: '*China will solidify its development basis by promoting Internet technology, infrastructure, [while] tackling the technological bottlenecks of industries and strengthening risk control.*'[163] In the context of the Internet Plus plan the Chinese government provides finance support and tax preferences to key projects. In this respect, in January 2017, the Government announced a RMB 100 billion investment fund for the internet development and the Internet Plus plan. The fund is overseen by The Cyberspace Administration of China and Ministry of Finance ('MOF').[164]

4.2.7. CENTRAL 13TH FYP

The 13th FYP does contain a number of quantitative targets,[165] most prominently the overall GDP growth[166] which is supposed to increase from RMB 67.7 trillion in 2015 to over RMB 92.7 trillion in 2020, thereby marking an annual growth of over 6.5%.[167] Otherwise, the wording of individual chapters in the 13th FYP is typically kept open and when reading the 13th FYP in isolation, it would be difficult to establish what precise measures the government

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[162] See Dexter, R. (2016). China's Supply Side is a far cry from Reagan's, *Bloomberg* https://www.bloomberg.com/news/articles/2016-09-08/china-s-supply-side-is-a-far-cry-from-reagan-s, (accessed on 29 August 2017).
[163] See The State Council website: http://english.gov.cn/policies/latest_releases/2015/07/04/content_281475140165588.htm (accessed on 29 August 2017).
[164] See Xinhua. (2017). *China launches 14.6 bln USD Internet investment fund*: http://news.xinhuanet.com/english/2017-01/22/c_136004874.htm (accessed on 16 October 2017).
[165] Grouped under the headings Economic Development, Innovation-driven Development, Wellbeing of People and Resources and the Environment (see Chapter 3 of the 13th FYP; see also section 4.3.2 below).
[166] Kennedy, S. and Johnson, K. (2016). *Perfecting China, Inc. The 13th Five-Year Plan*. Washington, DC: CSIS, p. 23: '*There was debate early in the planning process about whether to put aside this target in light of China's entry into the "new normal", in which the quality of growth should matter more than the absolute amount. However, it was felt that removing this target would have been too radical a step, and that local governments, if left without a national target constraint, would come up with wildly varying targets, making the national economy harder to manage*.'
[167] Ibid.

intends to take to steer the economy. For instance, the introduction to Part 3 of the 13th FYP pledges to '*achieve a proper balance in the relationship between government and market, make breakthroughs in the reform of key areas, and create new systems and mechanisms conducive to guiding the new normal in economic development.*'

This is further elaborated on in Chapter 17:

> *We will improve the macroeconomic regulation system, develop new methods of macroeconomic regulation, and strengthen the coordination of macroeconomic policies. We will work harder to create jobs, keep prices stable, make structural adjustments, raise efficiency, guard against and control risk, protect the environment, and guide market behaviour and public expectations, thereby fostering a stable macroeconomic environment for structural reform.*[168] (emphasis added)
>
> *We will exercise macroeconomic regulation based on long- and medium-term national development plans and objectives and total supply and demand. We will ensure that national development strategies and plans work to guide and constrain behaviour, and that all macroeconomic regulation policies are in line with and serve the needs of development.*[169]
>
> *Our work to balance total supply and demand and make structural improvements will continue, and the fundamental focus and policy orientation of macroeconomic regulation will be to keep the economy performing within an appropriate range and to improve its quality and performance.*[170]

Part 5 of the 13th FYP, titled '*An Optimized modern industrial system*', relates the above to the industrial area where the Chinese authorities intend to

> *carry* […] *out deep structural adjustment and revitalizing the real economy,* […] *move ahead with supply-side structural reforms, foster new industries while upgrading traditional ones, and move faster to put in place a new modern industrial system that has strong innovative capabilities, provides quality services, is based on close collaboration, and is environmentally friendly.*[171] (emphasis added)

Moreover, the authorities intend to implement the Made in China 2025 action plan, *'with an emphasis on strengthening the innovative capacity and basic capabilities of manufacturing* […]'.[172] As for traditional industries, the Chinese authorities will

> *transform and upgrade major manufacturing technologies and improve policies to support enterprises in emulating world-wide models in terms of techniques,*

[168] See 13th FYP, Chapter 17, Introduction.
[169] Ibid., Chapter 17, Section 1.
[170] Ibid., Chapter 17, Section 2.
[171] Ibid., Part 5, Introduction.
[172] bid., Chapter 22, Introduction.

> *processes, equipment, energy efficiency, and environmental protection, thereby helping key manufacturing sectors move into the medium-high end, […] improve the supply of consumer goods, […] encourage mergers and acquisitions of enterprises so as to put in place a highly concentrated, specialized, and cooperative industrial structure*[173] *with a core of conglomerate companies, […] support the development of specialized small and medium enterprises.* [174] (emphasis added)

Concerning emerging industries, the government will '*support the development of next generation information technology, new-energy vehicles, biotechnology, green and low-carbon technology, high-end equipment and materials, and digital creative industries. In fostering new areas of economic growth,* [they] *will spur innovation and industrial application in emerging, cutting-edge fields* […]'.[175]

In his 'Report on the Work of the Government in March 2016', Prime Minister Li Keqiang announced that Central government budgetary investment would be RMB 500 billion to spend on 13th FYP projects in 2016.[176] In addition, much more significant funding was reportedly provided by state-controlled banks and investment funds (see also chapter 6.6).[177]

4.2.8. SECTORAL PLANS AT NATIONAL LEVEL

At the level of national sectoral plans, the generic goals and targets of the national 13th FYP become more specific, taking the form of measures such as:[178]

a) General governmental control over industry sectors: market entry conditional upon complying with efficiency targets set in the respective plan (see Chapter 12); upgrading the industrial base coupled with phasing out outdated production (see Chapter 14.1.1);
b) Quantitative and qualitative development targets: setting improvement targets for various productions parameters, for instance annual labour productivity, material quality, ratio in which certain inputs are to be used or energy consumption, level of IT penetration in industrial manufacturing, level of R&D expenditures (see Chapter 14.1.1, see further Section 4.2.10);
c) Detailed production targets: for example, the National Mineral Resources Plan contains binding and indicative tonnages for a significant number of resources, ranging from natural gas to copper to lithium energy metal materials (see Chapter 12);
d) Governmental control over production capacity: specific methods of capacity control are envisaged in relevant sectors; these include also addressing the issue of overcapacity, e.g.

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[173] See Chapter 5 of this report.
[174] See 13th FYP, Chapter 22, Section 3.
[175] Ibid., Chapter 23, Section 1.
[176] http://english.gov.cn/premier/news/2016/03/17/content_281475309417987.htm accessed on 24 Nov 2017
[177] '*By the end of 2015, China had 780 government-connected investment funds, with a total value of RMB 2.18 trillion. Almost 300 funds, with RMB 1.5 trillion in capital, were created in 2015 alone'*. See Kennedy, S. and Johnson, K., (2016). *Perfecting China, Inc. The 13th Five-Year Plan*. Washington, DC: CSIS, p. 27.
[178] But not limited to.

by the effective withdrawal of low-efficiency production capacities or developing upstream and downstream alliances (see Chapter 14.1.1, see further Chapter 15.1.6);

e) Control of geographical industry distribution in China: specific industries are earmarked for being developed in or re-located to certain areas in line with other governmental policies (see in particular Chapter 14.1.1; see further Chapter 12.3.112); enterprises located in certain areas are encouraged to expand further (see Chapter 16.2.4);
f) Interventions into the structure of enterprises: specifying what type of enterprises in terms of size and ownership structure should be active in a given sector (see Chapter 12), envisaging consolidation of industrial sectors through mergers, sometimes explicitly aimed at reducing competition (see Chapter 14.1.1); support for setting up industrial alliances (see Chapter 12.3.1);
g) Development of specific industries: support being envisaged to industrial sectors manufacturing products identified by the plans (see e.g. Chapter 14.1.1 and 15.1);
h) Governmental steering of private initiatives: this is referred to as 'guiding' private capital into sectors selected by the government (see Chapter 12);
i) Industry support measures: financial support from the government to selected industries / industrial activities (see Chapter 12); encouraging cooperation between the financial sector and manufacturing industry (see Chapter 11.2); instructions to lower level of administration to explore possibilities to support selected industries (see Chapter 14.1.1); mechanisms to lower energy costs for selected industrial users (see Chapter 10 and see further Chapter 15.5,);
j) Ensuring security of supply: measures to support development of domestic industry in a given sector are envisaged (see Chapter 14.1.1).

Just as the central 13th FYP requires all government departments to carry out its implementation, the sectoral national plans also provide for rigorous implementation by relevant authorities. For example, according to Section VIII, Part 1 of the National Mineral Resources Plan, '*all regions shall effectively* […] *ensure the comprehensive implementation of tasks and objectives set out in the* […] *Plan* […]*'*. Part 4, entitled *'Strict supervision and management'* requires authorities, among other, to *'timely remedy any breach to the Plan, and where necessary, develop joint supervision and investigation with the relevant authorities.*' In addition, respective industry associations can be given the task of identifying potential issues of the plan's implementation and formulating corresponding policy suggestions (see Section 4.3.3 and Chapter 14.1.1).

4.2.9. PROVINCIAL GENERAL PLANS

Similar to the sectoral plans, the provincial plans provide more details on how the objectives of the central 13th FYP should be translated into policies within individual provinces. By way of an example, in the 13th Economic and Social Development Plan of Hebei Province the following types of government intervention measures can be found:

a) General governmental control over industry sectors: '*create regional innovation alliances, focus on the province's industrial development needs, encourage Hebei competitive enterprises to conclude alliances with enterprises, sectoral associations, academic institutions, scientific research institutes from Beijing and Tianjin so as to set up several*

strategic alliances for industrial and technological innovation.'[179] Furthermore, *'further withdraw the secondary sector [from urban areas] and promote the entry of the tertiary sector[into urban areas]" so as to ensure that the steel, chemical, electrical power and pharmaceutical growing enterprises that are located in inadequate urban areas are pushed away from cities*'[180]

b) Quantitative and qualitative development targets: '*significantly increase innovation capacities, visibly increase the overall level of R&D expenditures, upgrade industry towards a middle-range and high-end level, comprehensively resolve overcapacities in steel, cement, glass and other industry sectors,* […] *ensure that strategic emerging industries represent at least 20% of the large-scale industry's added value.*' [181] Furthermore: '*support undersized enterprises to expand and become stronger, speed up growth of large enterprises,* […] *and ensure that by 2020 the number of large size industrial enterprises at Province's level reaches 20 000 with an added value of RMB 1.5 trillion.*'[182]

c) Detailed production targets: '*streamline and set up large-size highly efficient coal-fired units, […] strengthen regional support to electrical power: by 2020, the installed capacity of electrical power shall reach 98 million kW and the generating capacity shall reach 348.5 billion Kwh; further develop conventional and non-conventional oil and gas resources exploration, and stabilise oil and gas production volume above 5.9 million tonnes and 900 million cubic meters, respectively; consolidate the development of a coastal petrochemical base and transfer refining enterprises towards Caofeidian, set up large-size consolidation programmes for refining activities, speed up the quality upgrade of oil products, and increase the crude oil processing capacity to above 73 million tonnes.* '[183]

d) Governmental control over production capacity: '*implement differentiated prices for electricity and water, consider incentive policies, make full use of market, economic, legal, as well as administrative tools to proceed to forced market withdrawal of production capacities that are not up to the standards, to speed up the elimination of obsolete production capacities,* […] *and to contain production capacities for steel, cement and glass at respectively 200 million tonnes, 200 million tonnes and 200 million weight cases approximately.* '[184]

e) Control of geographical industry distribution in China: '*speed up the setting up of innovative cities in Shijiazhuang, Tangshan, Baoding, Langfang, foster a series of innovative districts (areas, cities); efficiently use favourable conditions of all sorts of economic development zones, high-tech areas, scientific and technological parks;* […];

[179] See Hebei 13th FYP, Section II-4.
[180] Ibid., Section III-6.
[181] Ibid., Section I-2.
[182] Ibid., Section III-6.
[183] Ibid., Section VIII-27.
[184] Ibid., Section III-6.

encourage and support Beijing and Tianjin makerspaces to set up subsidiaries in Hebei; by 2020, the number of makerspaces[185] *at provincial level shall reach 300 at least.*'[186]

f) Interventions into the structure of enterprises: '*promote the restructuring of enterprises, support strategic cooperation and mergers and acquisitions between enterprises, speed up structural organisation reform and process reengineering, promote enterprise restructuring in key sectors such as steel etc., expand enterprise groups having a competitive advantage.*'[187]

g) Development of specific industries: The Hebei Province 13th FYP earmarks a number of '*traditional industries having a competitive advantage*' for transition and upgrade and lists a number of selected projects in these sectors:

1. *Equipment manufacturing: Great Wall automobile's new 500 000 vehicles and spare parts, Beijing Modern Factory in Canzhou, Geely Automobile Group - Volvo vehicles and motors, China aerospace production base for the Long March Rocket* […]
2. *Metallurgy: Environmental protection, relocation, product upgrade and reform at HBIS, Second phase of the Shougang Jingtang Iron and Steel project,* […]
3. *Chemical industry: Sinopec in Caofeidian: 10 million tonnes of refined oil; Sinopec North China: 10 million tonnes of refined oil;* […]
4. *Light industry and food: China branding innovation base for furniture; Hengshui Industrial District: park for textile industry;* […]
5. *Construction materials* […].[188]

Similarly, key projects are listed for the SEIs:

1. *Advanced equipment manufacturing: Tangshan (city): railways high-speed passenger trains; Xianghe (county): incubator base for smart robot industry* […]
2. *Electronic and information technology* […]
3. *Bio-industry* […]
4. *New energy sources* […]
5. *New materials* […]
6. *Energy saving and environmental protection* […]
7. *New energy cars* […][189]

h) Governmental steering of private initiatives: '*By 2020, have 80 000 science and technology SMEs, 3 500 high-tech enterprises.*'[190]

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[185] According to the State Council, makerspaces are innovation and entrepreneurship incubators where enterprises, research institutions and colleges should work together in the emerging sectors such as manufacturing, electronics and service, see http://english.sina.com/china/p/2016/0218/891506.html, (accessed on 1 August 2017).
[186] See Hebei 13th FYP, Section II-5.
[187] Ibid., Section III-6.
[188] Ibid., Table 4 in Section III-6.
[189] Ibid., Table 5 in Section III-6.
[190] Ibid., Section II-3.

i) Industry support measures: '*support leading enterprises in industries such as steel, equipment, construction materials, pharmaceuticals, chemicals, food products to* […] *develop so as to become leading innovative enterprises with international competitiveness.*'[191]

In addition to the general FYP, provinces also outline planned government support in other documents, such as in the lists of key investment projects. Such compilations of projects may reflect not only the priorities of the respective central and provincial FYPs but can also be based on the strategic initiatives (such as, for example, Made in China 2025) and other relevant policy guidelines by the central authorities. The Hebei Province has established a list of key investment projects in January 2016.[192] The list introduces three categories of key projects at the provincial level. It counts 340 projects, subdivided into three categories of 120, 100 and 120 projects, respectively. This list which effectively represents a list of companies earmarked for support from the provincial government was updated in May 2016[193] as follows:

Group 1: Projects aiming at planning and start of operations (120 projects/enterprises)
i-Strategic emerging industries (64)
1. Advanced manufacturing equipment (21)
2. Electronics and IT (12)
3. New materials (11)
4. New energy cars (1)
5. Bio-industry (6)
6. Energy saving and environmental protection (4)
7. New energy sources (9)
ii-Modern services (20)
iii-Upgrading traditional industries (23)
1. Equipment manufacturing (6)
2. Metallurgy (3)
3. Light industry (10)
4. Chemical industry (3)
5. Construction (1)
iv-Industrialisation of agriculture (5)
v-Infrastructures (8)
1. Energy (5)
2. Transport (3)

[191] Ibid., Section II-3.
[192] See Hebei DRC, 2016 年河北省重点项目公示, http://www.hbdrc.gov.cn/web/web/zdb_gzdt/4028818b521b189e01522e4cdb967a1e.htm, accessed on 11 August 2017.
[193] See the full lists at: http://www.hbdrc.gov.cn/web/web/zdb_ndjh/4028818b547a2b60015484a55efa3606.htm (batch 1), http://www.hbdrc.gov.cn/web/web/zdb_ndjh/4028818b5496109a01549dd2e60a509b.htm (batch 2), http://www.hbdrc.gov.cn/web/web/zdb_ndjh/4028818b5496109a01549dd4e40d5194.htm (batch 3); accessed on 8 August 2017.

Group 2: Projects aiming and continuing construction and getting fully operational (100)

i-Strategic emerging industries (45)

1.Advanced manufacturing equipment (22)

2. Electronics and IT (8)

3. New materials (4)

4. New energy cars (1)

5. Bio-industry (5)

6. Energy saving and environmental protection (3)

7. New energy sources (2)

ii-Modern services (17)

iii-Upgrading traditional industries (28)

1. Equipment manufacturing (4)

2. Metallurgy (3)

3. Light industry (11)

4. Chemical industry (9)

5. Construction (1)

iv-Industrialisation of agriculture (4)

v-Infrastructures (6)

1. Energy (3)

2. Transport (3)

Group 3: Pre-projects (120)

i-Strategic emerging industries (70)

1.Advanced manufacturing equipment (23)

2. Electronics and IT (16)

3. New materials (9)

4. New energy cars (9)

5. Energy saving and environmental protection (5)

6. New energy sources (8)

ii-Modern services (31)

iii-Upgrading traditional industries (14)

1. Equipment manufacturing (1)

2. Metallurgy (3)

3. Light industry (4)

4. Chemical industry (6)

iv-Infrastructures (5)

1. Energy (1)

2. Transport (4)

The figures in brackets indicate the number of supported projects in a given category and at this level, the list eventually reveals the individual recipient companies. This can be illustrated by a number of examples:

‘*Advanced manufacturing equipment* [in Group 1(i)]:

- *Fucheng Qianjin Automobile Lighting Co.,Ltd: High-end smart AFS systems for sedan cars*
- *Baoding Jinyang Lijin Cable Manufacturing Co. Ltd: new types of cables*
- *Jingjin Electric (Beijing) Co. Ltd: New energy car drive assembly and energy storage systems* […]

Metallurgy [in Group 1(iii)]:

- *Shougang Jingtang United Iron and Steel Co. Ltd: Shougang Jingtang Iron and Steel factory-second phase*
- *Hebei Youyang Iron and Steel Co. Ltd: industry restructuring, transfer away from the city, equipment upgrading*
- *Tangshan Iron and Steel Group Co. Ltd: High-strength automobile panels, phase 2* […]

Construction [in Group 1(iii)]:

- *Hebei Hangxiao Steel Structure Co. Ltd: steel pipe fittings*

Advanced manufacturing equipment [in Group 2(i)]:

- *Great Wall Motor Co. Ltd: Base for complete vehicles and spare parts* […]

Equipment manufacturing [in Group 2(iii)]:

- *Hebei Boyuan Technology Co. Ltd: deep processing of cold-rolled precision stainless steel* […]

Metallurgy [in Group 2(iii)]:

- *Shijiazhuang Iron and Steel Co. Ltd: environmental protection, relocation, product upgrade and transformation*
- *Tangshan Nickel Gold Industrial Co. Ltd: Nickel alloy production and deep processing* […]

Metallurgy [in Group 3(iii)]:

- *Tangsteel Bohai Iron and Steel Co. Ltd : joint restructuration, transfer away from the city and transformation*
- *Chinalco: Port of Huanghua, 4 million tonnes of aluminium oxide* […]

Light industry [in Group 3(iii)]:

- *Baoding Swan Fibres Co. Ltd: Solvant spun short cellulose fibres: transfer from the city into a park, technology transformation* […]

Chemical industry [in Group 3(iii)]:

- *Great United Petroleum Co. Ltd and Formosa Plastic Group: smelting integration.*

In March 2016,[194] the Hebei government published the Implementing Plan to enhance annual activities related to Hebei Province's key projects (‘Key Projects Plan’).[195] According to this

[194] Hebei Government publishes an Implementing Plan to enhance annual activities related to the Key Projects 24 March 2016, 省政府出台重大项目提升年活动实施方案 http://www.hbdrc.gov.cn/web/web/xxgkzcjd/4028818b541e1c97015428963e39574f.htm, accessed on 16 October 2017.

plan, the province would focus on implementing *'3-2-6'* key projects. The code *'3-2-6'* refers to implementing the abovementioned 3 categories of projects at provincial level, 2 000 key-projects at municipal level and to strive to achieve RMB 600 billion investment in the course of 2016 on projects in the 3 categories. Importantly, even though no precise definition of '*key projects*' or information on the substance of individual projects in the above list is available (however, see Chapter 12.3.2), the Hebei government has specified the volume of finances attributed to these projects.[196] The 220 projects in group 1 and group 2 are to account for a total investment of RMB 1 070.64 billion (with RMB 236.33 billion in 2016), with another RMB 1 110.65 billion to be invested into the 120 projects in group 3.[197] As for the 2 542 key municipal projects the total investment should amount to RMB 3 445.91 billion (with RMB 535.15 billion investment annually).[198]

This staggering amount exceeding RMB 5.5 trillion for investment into a number individual projects should be spent by respecting six priorities listed in the Implementing Plan to enhance activities related to Hebei Province's key projects (Hebei Government 2016/39):

1. - *speed up the promotion of coordinated development projects,*
   - *speed up the construction of the New Capital Airport economic zone, coordinated parks and areas such as the Caofeidian coordinated development demonstration area, the Hebei-Tianjin circular economic and industrial demonstration area, etc.*
   - *keep on promoting the three following sectors: transports, ecology and environmental protection as well as industry in order to achieve a breakthrough;*
2. - *speed up the promotion of a number of projects implementing coastal area planning,*
   - *plan and promote the key infrastructure construction project called "three harbours- four areas",*
   - *focus on promoting coastal area's bases for equipment manufacturing, fine steel products, petrochemicals, modern logistics etc, as well as large parks and their backbone support programmes,*
3. - *speed up the promotion of a number of transformation and upgrade programmes,*
   - *focus on enhancing supply-side structural reforms,*
   - *speed up the implementation of a number of innovation parks, innovation platforms and innovation programmes,*

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[195] A follow-up plan for 2017 was published in April 2017 (see http://www.hbdrc.gov.cn/web/web/xwbd/4028818b5b8e2dd2015b9db2fc515542.htm, accessed on 11 August 2017) which updates the list of key projects and contains further specifications.

[196] See Hebei News. (2016). 年河北省重点项目计划发布, Available at: http://hebei.hebnews.cn/2016-01/25/content_5304052.htm, accessed on 8 August 2017.

[197] See Hebei DRC website, 上半年省市重点项目完成投资 5718.7 亿元: http://www.hbdrc.gov.cn/web/web/xwbd/4028818b56610e0c0156d3ade8022bb5.htm (accessed on 8 August 2017).

[198] See Hebei DRC website, 省政府出台重大项目提升年活动实施方案, Available at: http://www.hbdrc.gov.cn/web/web/xxgkzcjd/4028818b541e1c97015428963e39574f.htm (accessed on 8 August 2017).

- *support industry sectors and products to move up towards the mid-high range;*

4. - *speed up the promotion of a number of environmental comprehensive management programmes,*
   - *speed up projects organising clean energy and distributed power,*
   - *strongly promote the preliminary works for the Haixing power station,*
   - *promote the ecological rehabilitation key projects such as the ecological rehabilitation of Baiyang Lake, the ecological rehabilitation of Hengshui Lake,*
   - *build an ecological security system for a sustainable development;*
5. - *speed up the promotion of a number of infrastructure projects,*
   - *as a priority, promote the preliminary works for the Beijing-Tangshan, Gu'An-Baoding, Langfang-Zhuozhou intercity lines,*
   - *achieve the construction of programmes such as Beijing New Airport, Shijiazhuang railways transport, Yellow River water transfer toward Hebei Baiyangdian;*
6. - *speed up the promotion of a number of County-level economic projects,*
   - *strongly implement the "strong industry counties" strategy,*
   - *speed up the construction of development areas and industry parks,*
   - *actively plan and implement a number of "strong county projects" featuring large-sized investments, a strong impact and a strong support,*
   - *expand specific brands, strengthen sectors considered as pillars.*[199]

The Key Projects Plan and the list of key projects constitute one of the points where the policy settings of the plans are subsequently implemented through the actual allocation of financial resources by the government. Even though a considerable portion of the investment is likely to be spent on projects which are not objectionable in the context of this report (infrastructure, housing), the language of the Key Projects Plans shows equally clearly that the interventionist toolkit of setting development targets, supporting selected industrial sectors, control over geographical distribution of industry etc. remains essentially the same as in the general provincial plan and the higher level plans.

4.2.10. PROVINCIAL SECTORAL PLANS

The Hebei province Petrochemical 13th FYP[200] provides an example of how the policy objective and targets are passed from the national level onto the next level of administration. Following a review of the achievements under the 12th FYP, the plan identifies the main problems for the upcoming five years period, such as the need to improve the product structure. Another issue pertains to the fact that, even though the province's crude oil processing capacity has expanded, the level of the petrochemical industry's development of ethylene, aromatic hydrocarbons etc. was not sufficient, which led to production restriction of

[199] Translation of the Implementing Plan summary on the Hebei NDRC website: http://www.hbdrc.gov.cn/web/web/xxgkzcjd/4028818b541e1c97015428963e39574f.htm (accessed on 8 August 2017).
[200] Full text available on the website of the Hebei DRC (www.hbdrc.gov.cn/).

downstream organic chemical raw materials. Another problem identified by the Plan is that core competitiveness is not strong:

> *Leading enterprises are scarce, Hebei's petrochemical industry is essentially composed of SMEs. In 2015, among the top 500 Chinese petrochemical enterprises, 41 were located in Hebei while 104 were located in Shandong and 53 in Jiangsu. […]. In 2015, Hebei's petrochemical industry sales/profit ratio amounted to only 3.32%; This is a relatively important gap compared to the domestic average 4.93% and this is far behind Fujian's ratio 10.25%, Shandong 7.59%, Jiangsu 5.96%. Particularly since 2013 the overall profit volume started to gradually go down.*[201]

In its next section, the general idea of the plan is outlined as follows:

> [Hebei shall]
>
> *- implement everywhere the spirit of the 18th National Congress and the third, fourth and fifth plenary meetings of the 18th Central Committee,*
>
> *- firmly seize opportunities resulting from the coordinated development of the Beijing-Tianjin-Hebei area and in the Bohai surrounding area,*
>
> *- strongly implement innovation-driven strategies as well as the "Made in China 2025" and "Internet+" action plans,*
>
> *- further ensure scale expansion, industry chain extension, intensification and concentration as well as circular development, in accordance with the concept of "expanding and strengthening the petrochemical industry, extend the coal chemical industry chain, orderly develop the salt chemical industry, strongly develop the fine chemical industry".*[202]

The main development goals in terms of industrial scale include:

> *i Industry scale: By 2020, across the whole province, the added value of petrochemical industries above a certain size shall reach RMB 220 billion and an average yearly growth of approximately 9.8%. The crude oil overall processing capacity shall exceed 50 million tonnes. […]*
>
> *ii Industry optimization: By 2020, [Hebei shall]*
>
> *- ensure the setting up of the basic framework for the Caofeidian chemical industry base and ensure a crude oil overall processing capacity exceeding 30 million tonnes;*

[201] See Hebei petrochemical 13th FYP, Section I-2.
[202] Ibid., Section II-1.

- expand the scale of the synthetic material base located in the new Bohai area,

- ensure the emergence of synthetic material industry clusters focussing on PVC, caprolactam (nylon), TDI, MDI (polyurethane), polypropylene, polyester;

- make sure that the petrochemical industry located in the coastal areas raises its share of the added value generated in the whole province from 38.3% in 2015 to over 45% […]

iii By 2020, R&D expenditures shall account for more than 1.5% of the whole sector's operational income..... The number of enterprises' technological centers at provincial level and above shall eventually reach 100. Fine chemical products shall account for 60%.

iv- Energy saving and emission reduction: (Hebei shall)-reduce its energy consumption per million units of added value by more than 10% compared to the 12th FYP;-reduce by 15% the volume of chemical oxygen demand, and the volume of emissions of ammoniacal nitrogen, sulphur dioxide, nitrogen oxide and other major pollutants.[203]

The following section, which represents the bulk of the plan, lists a number of further more specific goals:

[Hebei shall]

-strive to reach, by 2020, a yearly production of more than 30 million tonnes of refined oil, and 3 million tonnes of PX,

-set up complete production equipment of products for which there is an urgent market demand, i.e.: polymer materials, organic chemical raw materials, and high-end fine chemical products,

-speed up the development of products for which there is high degree of import-dependence such as ethylene glycol, styrene, acrylonitrile etc.,

-raise the security of supply capacity for organic raw materials;[…]

-by 2020, develop a production capacity for synthetic materials and their intermediate products exceeding 4 million tonnes;[…]

-speed up the development of projects concerning the comprehensive use and deep processing of downstream products such as 400 000 tonnes of caprolactam, 300 000 tonnes of cyclohexanone, as well as light hydrocarbons,

[203] Ibid., Section II-3.

-strongly develop the sector of new chemical materials as the leading fine chemical industry […];

-focus on the development of high-performance adhesives such as urea formaldehyde glue, adhesives used for the aeronautics and aerospace sectors, for solar power batteries, wind power so as to support strategic and emerging sectors[…];[204]

Nitrogen fertilisers:[…]raise the share of low cost raw materials such as bituminous coal and lignite,-speed up the development of specific use fertilisers, liquid fertilisers, mixed organic and non-organic fertilisers etc.,[…]focus on fostering the building of the second-phase of the Cangzhou Zhengyuan 600 000 tonne- ammonia facility.[205]

Similarly, the plans focus on developing high-end organic chemical products:

(Hebei shall)

- speed up the development of basic organic raw materials for the chemical industry as well as of high-end organic chemical products for which there is a relatively large domestic shortage and for which market competitiveness is strong, such as phenol / acetone, 1.3 propanediol, 1.4 butanediol, biphenol A, adiponitrile, adipic acid, hexanediol, hexamethilenediamine, tertiary carbon acid, high carbon alcohol (C14-16), fluorinated carbon alcohol, polyether polyol, cyclohexanone, isocyanate (TDI, MDI, ADI), dimethyl-carbonate, pyridine,

- encourage the development of 5 major separated and deeply processed intermediate products for agro-pharmaceuticals and pharmaceuticals such as ethylene-oxidation-based ethylene glycol, propylene-direct-oxidation-based propylene oxide, glycerol-based epichlorohydrin, butadiene-based adiponitrile and pyrolised carbon. [206]

The final section of the plan contains a set of organizational measures to achieve the goals set out in the previous section. Such measures include general ideas of strengthening organisation and leadership, simplifying approval procedures, strengthening the role of the industry regulators, improving the level of workforce skills and education[207] but also a range of measures which make it possible for the Hebei government to directly intervene into the industry. Such support measures include:

[204] Ibid., Section III- 2.
[205] Ibid., Section III- 3.
[206] Ibid., Section III-4.
[207] Ibid., Section IV-1, IV-2, IV-5, IV-7.

Implement specific tax preferential policies to support industry upgrading at national level; actively seek support from all types of national specific funds; fully absorb state-owned capital and private capital; strongly support efforts to develop key areas and breakthrough achievements, key projects, pilot and demonstration projects etc.; encourage banks and financial institutions located in the province to adjust credit structure as regards the focus given to support amount, maturity, interest rates etc.; encourage financial capital, venture capital, and private capital to focus investments on key areas. -set up a credit risk compensation mechanism for manufacturing technology innovation and smart manufacturing enterprises.[208]

Protect supply factors: clean up and revitalize land left unused; intensify the use and saving of land resources; encourage land supply modes for industrial use such as long-term rental, lease followed by sale, combined leasing/selling etc.; speed up land use administrative procedures for industry parks; alleviate the land-use related financial pressure. In principle, land occupied by industry enterprises relocated in any kind of industry park returns to the Ministry of Land Resources: the net income resulting from the transfer of land use rights is used to support the enterprises' development […] priority shall be given to key projects contributing to the petrochemical industry's upgrading.[209]

Strict market access: [Hebei shall][…] strictly implement the sector entry conditions,- control any new production capacity project regarding coke, caustic alkali, sodium carbonate, sulphuric acid, calcium carbine pvc, methanol, dyes etc.[210]

4.2.11. INDUSTRIAL RESTRUCTURING – DECISION NO 40

The Decision of the State Council Regarding Promulgating the Implementation of Interim Provisions on the Promotion of Industrial Restructuring ('Decision No 40'),[211] is very important in the context of China's industrial restructuring. Published in 2005 as an implementing measure of the 11th FYP, Decision No 40 remains in force. Decision 40 which is an order of the State Council, covers all areas of the economy including agriculture, transport, environment, development of manufacturing industry, hi-tech industry and the service industry. Chapter III of Decision 40 provides guidance with regard to achieving the goal of industrial restructuring by setting out how the Guidance Catalogue for the Industrial Structure Adjustment[212] (applicable to enterprises within China) and the Guidance Catalogue

[208] Ibid., Section IV-3.
[209] Ibid., Section IV-4.
[210] Ibid., Section IV-6.
[211] Decision of the State Council Regarding Promulgating the Implementation of Interim Provisions on the Promotion of Industrial Restructuring, 2 December 2005, Guo Fa [2005] No.40.
[212] The first Guidance Catalogue for the Structural Adjustment of Industry was issued in 2005 (NDRC, Order [2005] No. 40, issued December 2, 2005). The most recent edition is the Guidance Catalogue for the Structural

for Foreign Invested Industries (applicable to foreign funded enterprises) is formulated.[213] In this context the Decision states that the Guidance Catalogue for the Industrial Structure Adjustment will divide industrial sectors into 'Encouraged', 'Restricted' and 'Eliminated'[214] categories. The sectors within each of the categories are described in broad terms e.g. in the encouraged category:

> *The encouraged category mainly includes the key technologies, equipment and products to have important promoting functions to economic and social development, to conducive to resource saving, environmental protection, and industrial structure optimization and upgrading, and require to be encouraged and supported by policies and measures.*[215]

Inclusion of a sector in the 'Encouraged' sector clearly implies preferential treatment:

> *The encouraged investment projects shall be examined, approved, ratified or archived in accordance with the relevant provisions of the state on investment administration. All financial institutions shall provide credit supports in compliance with credit principles. The equipment imported within the total amount of investments for self-use, except for the commodities listed in the "Catalogue of Non-tax Free Imported Commodities for Domestic Investment Projects (Amended in 2000)" promulgated by the Ministry of Finance, shall still be exempted from customs duties and import value-added tax, and shall, after the new provisions such as the catalogue of investment projects on non-exempted tax have been promulgated, be governed by such new provisions. As for other preferential policies on encouraged industry projects, the relevant provisions of the state shall be applied (emphasis added).*[216]

As regards the 'Eliminated' category, investment is prohibited with clear instructions regarding the actions to be taken to ensure no such investment takes place:

> *Investments are prohibited from being contributed to projects under the eliminated category. All financial institutions shall stop various forms of credit granting supports to such projects, and take measures to take back the granted loans. All localities and departments as well as the relevant enterprises shall take powerful measures to eliminate such projects within the prescribed time limit. The state price administrative department may, within the time limit for elimination, raise the electricity price. No production technique, equipment or product to be*

Adjustment of Industry (issued in 2011, revised in 2013) (NDRC, Order [2013] No. 21, issued February 16, 2013).

[213] Decision No. 40, Chapter III, Article 12.

[214] Ibid., Article 13.

[215] Ibid., Article 14.

[216] Ibid., Article 17.

eliminated by the state by explicit order may be imported, transferred, produced, sold, used or adopted.[217]

New investments in the 'Restricted' category are prohibited with clear guidelines on how this is to be pursued.

The new investments project under the restricted category shall be prohibited.. The investment administrative department shall not examine, approve, ratify or archive the projects under the restricted category. No financial institution shall grant loans for such projects, and no administrative department of land administration, urban planning, construction, environmental protection, quality inspection, fire prevention, customs, or industry and commerce, etc. shall handle the relevant procedures for such projects.[218.]

Decision No 40 also sets outs the repercussions for failure to comply with the provisions under both the restricted and eliminated categories:

*[*Restricted*]: In case of any violation of the provisions to carry out construction based on investment or financing, the relevant entities and persons shall be subject to liabilities*.[219]

*[*Eliminated*]*: *If any enterprise violates the provisions, its persons directly held liable and the relevant leaders shall be subject to liabilities in accordance with the law*.[220]

Decision No 40 states that the Guidance Catalogue for the Industrial Structure Adjustment, which is an implementing measure of Decision No. 40, is an important basis for guiding investment directions. It guides the government to administer investment projects, and to formulate and enforce policies on public finance, taxation, credit, land, import and export.[221]

4.2.12. SUBSTANCE OF PLANS – SUMMARY

The above description and examples demonstrate the essential features of the Chinese planning system in terms of substance, namely that broadly formulated industrial policy goals from the higher level plans are reflected and translated into more specific targets and implementing measures with each successive plan at the respective level below.

When looking at the entirety of the planning system in China, it becomes apparent what the general notions of the central 13th FYP effectively mean. The concept of '*upgrading traditional industries*' and '*fostering new industries*' (see section 4.2.7) is turned into a list of individual product / product ranges in selected industrial sectors (see sections 4.2.8, 4.2.9 above and 4.2.10). The reference to '*encouraging mergers and acquisitions*' or '*putting in*

[217] Ibid., Article 19.
[218] Ibid., Article 18.
[219] Ibid.
[220] Ibid., Article 19.
[221] Ibid., Article 12.

place cooperative industrial structure' (see section 4.2.7) results in eliminating competition through mergers and (re)locating industry according to industry policy decisions (see sections 4.2.8e),f), 4.2.9e),f) and 4.2.10). And the category '*supporting enterprises*' (see section 4.2.7) can in fact amount to any kind of governmental support, not least financial (see sections 4.2.8i), 4.2.9i) and 4.2.10) etc.

4.3. IMPLEMENTATION OF PLANS

4.3.1. BINDING NATURE OF PLANS

The status and importance of the plans in the economic governance of China is recognised and addressed in the Constitution which attributes the power to approve the central FYP to the NPC. According to the Constitution:

> *The National People's Congress exercises the following functions and powers: […]*
>
> *(9) to examine and approve the plan for national economic and social development and the report on its implementation.*[222]

Accordingly, the central 13th FYP was adopted in March 2016 by the NPC.[223] Preparing the draft FYP for the legislator's approval is the task of the State Council, as stipulated in Article 89 of the Constitution:

> *The State Council exercises the following functions and powers: [...]*
>
> *(5) to draw up and implement the plan for national economic and social development and the State budget.*[224]

Despite this strong constitutional backing, Chinese sources would sometimes claim that the plans lack a binding character,[225] mainly because they do not have a place in the ranking table of authoritative legislative documents under the Legislation Law of the People's Republic of China.[226]

However, the fact that the FYPs (or the overarching strategies) do not have a precisely defined status within the Chinese legal order does not undermine their important role in guiding the direction of the economy. Neither does it put in question their binding nature which transpires from other pieces of legislation, such as the Organic Law of the Local

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[222] See Article 62 of the Constitution.
[223] See at: http://www.npc.gov.cn/npc/zgrdzz/site1/20160429/0021861abd66188d449902.pdf, accessed on 8 August 2017.
[224] See Article 89 of the Constitution.
[225] Kennedy, S. and Johnson, K. (2016). *Perfecting China, Inc. The 13th Five-Year Plan*. Washington, DC: CSIS, p. 1.
[226] Adopted by the 3rd session of the 12th National People's Congress on 15 March 2015 (Chinese version available at: http://www.npc.gov.cn/npc/dbdhhy/12_3/2015-03/18/content_1930713.htm, (accessed on 29 August 2017). See in particular Chapters 2-4 of the Law.

People's Congresses and Local People's Governments of the People's Republic of China.[227] This law unequivocally obliges said authorities to implement the FYPs. Its Article 8 reads as follows:

> *The local People's Congresses at or above the county level shall exercise the following functions and powers:*
>
> *(1) to ensure the observance and execution, in their respective administrative areas, of the Constitution, the law, administrative rules and regulations and the resolutions of the people's congresses and their standing committees at higher levels, and to ensure the implementation of the state plan and the state budget;*
>
> *(2) to examine and approve the plans for national economic and social development and budgets of their respective administrative areas and the reports on the implementation of such plans and budgets; [...]*

And Article 44 stipulates:

> *The Standing Committee of Local People's Congresses at or above the county level shall exercise the following functions and powers: [...]*
>
> *(5) to decide, upon the recommendation of the people's government at the corresponding level, to make partial alterations in the plans for economic and social development and the budgets of its respective administrative area.*

According to Article 59:

> *The local People's Governments at or above the county level* shall exercise the following functions and powers: *[...]*
>
> *(5) to implement the national economic and social development plan, budget, management of the administrative region of the economy, education, science, culture, health, sports, environmental and resource protection, urban and rural construction and finance, civil affairs, public security, national affairs, Administrative, supervisory, family planning and other administrative work; [...]*

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[227] Adopted at the 16th Session of the Standing Committee of the 12th National People's Congress on 29 August 2015 (English version available e.g. at (limited access): http://app.westlawchina.com/maf/china/app/document?&docguid=i0a231c3e0000014f81d863b65d0ec610&hitguid=i0a231c3e0000014f81d863b65d0ec610&srguid=i0ad82b440000015dc654d9ac94edbbcb&spos=3&epos=3&td=1485&crumb-action=append&context=9&lang=en , accessed on 10 August 2017; Chinese version available at: http://news.xinhuanet.com/legal/2015-08/30/c_128180120.htm, (accessed on 10 August 2017).

And Article 61 prescribes that:

> *The People's Governments of townships, nationality townships and towns shall exercise the following functions and powers: [...]*
>
> *(2) to implement the plan for economic and social development and the budget of its administrative area and conduct administrative work concerning the economy, education, science, culture, public health, physical culture, finance, civil affairs, public security, judicial administration and family planning in its administrative area*; *[...]*.

These legislative requirements for all levels of administration to implement the respective FYPs fully correspond to the wording of the plans themselves which presumes that the plans will be observed. For instance, the final chapter of the 13th FYP sets out the modalities for its implementation and calls on all participants to ensure its successful application:

> *We will strengthen overall management and coordination, creating a development planning system headed by the plan for economic and social development, and supported by subject-specific, regional, local, and annual plans. Relevant departments under the State Council shall organize the formulation of a set of national subject-specific plans—particularly key subject-specific plans—which set out in detail the implementation of the main tasks and targets of this plan. Local governments should, in their development plans, ensure that their development strategies, main targets, key tasks, and major projects are in coordination with those defined in the national plans and implement the unified arrangements provided for in these plans. We will work faster to see the promulgation of the Law on Development Plans.* (emphasis added)

And further:

> *All local governments and government departments must work hard to organize, coordinate, and guide the implementation of this plan. We will carry out dynamic monitoring and evaluation of the implementation of this plan, use the results produced as an important basis for improving government work and measuring performance, and report the implementation of this plan to the Standing Committee of the National People's Congress in accordance with the law and willingly accept its oversight. Responsibility and requirements regarding progress must be made clear in order to ensure that the obligatory targets, projects, initiatives, policies, and reform measures specified in this plan are all carried out as scheduled. Approval procedures related to the projects and initiatives included in this plan will be streamlined and priority will be given to them in site selection,*

land availability, and funding arrangements. We will ensure that auditing offices play a role in overseeing implementation.[228]

Similarly to the central 13th FYP, provincial and municipal plans also provide for rigorous implementation by relevant authorities.

For example, the 13th FYP for the Construction Material Industry addresses the roles of the administration as well as that of enterprises in setting out the modalities to implement the plan: '*The present plan's implementation shall be ensured by the administration in charge of industry together with the relevant administrations so as to duly implement the present plan's development objectives, main tasks and major projects* […] *Fully involve enterprises as pillars in the implementation process of the present plan.* '[229]

The 13th FYP for Mineral Resources contains a section dedicated to 'Plan implementation and management' which uses language such as: '*It is necessary to clearly define* […] *responsibilities and tasks regarding the plan's implementation,* […] *ensure the effective implementation of each task set out in the Plan'.*[230] (emphasis added) That plan goes on to state '*China shall* […] *timely remedy any breach to the Plan, and where necessary, develop joint supervision and investigation with the relevant authorities.* '[231] (emphasis added)

Regarding implementation of provincial plans, the Guangdong 13th FYP not only contains the commitment to implement the plan, but also relies on the Party's leadership when referring to the binding nature of the plan: '[Guangdong shall] *stick to the Party's leadership, further renew and improve the Plan's implementation mechanisms, fully use the plan's guiding function as regards resource allocation, strengthen and improve macro-control and coordination, strengthen the plan's binding character, strengthen supervision and evaluation, ensure the efficient implementation of the Plan.* '[232] (emphasis added)

The municipal level plans also have provisions ensuring strict implementation. For instance, the Zhangjiagang Municipal Plan states '[…] *Resolutely pay attention to implementation, in order to fully complete the 13th Five-Year-Plan's objectives and tasks* […]. '[233]

In view of the above, it is apparent that the implementation is resolutely addressed across plans at every level. This cannot be dismissed as simply aspirational language since the implementation of plans is mandated by law, including by the Constitution. In addition, the plan implementation and fulfilment of targets set by various plans are regularly monitored and evaluated (see section 4.3.2 below).

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[228] See 13th FYP, Chapter 80, Sections 1 and 2 (emphasis added).
[229] See Construction Sector 13th FYP, Section VI – Safeguard measures.
[230] See 13th National Mineral Resources FYP, Section VIII.
[231] See National Mineral Resources 13th FYP, Part 4 – Strict Supervision and Management.
[232] See Guangdong 13th FYP, Section III.
[233] See Zhangjiagang Municipal 13th FYP, Section IX-4.

4.3.2. MONITORING/EVALUATION OF FIVE YEAR PLANS' IMPLEMENTATION

As mentioned in the previous section, plans are not simply drawn up but they are expected (and legally mandated) to be implemented. This is evidenced not only by the level of detail and the setting of targets, but by the systematic review, monitoring and reporting mechanisms that are established and executed for the FYP at all levels.

The 13th FYP states: '*We will carry out dynamic monitoring and evaluation of the implementation of this plan, use the results produced as an important basis for improving government work and measuring performance, and report the implementation of this plan to the Standing Committee of the National People's Congress in accordance with the law and willingly accept its oversight*'[234] and further:

> *We will strengthen coordination between budgeting and the implementation of this plan, and having clearly defined the spending responsibilities of each level of government, we will ensure that budgeting at each level supports implementation. Medium-term fiscal plans and annual budgets should, based on both the tasks and targets defined in this plan and a government's own financial strength, contain well designed spending scales and structures. We will work faster on government investment legislation.*[235]

Monitoring and evaluation means that targets are set against which progress can be measured. These drive the projects, initiatives, policies, and reform measures specified in the plans while also determining the schedule.

In addition, moving forward in the planning process requires a stocktaking of the achievements and serves to steer the way ahead. As mentioned in section 4.2.8, the 13th FYP sets out, under the various sections, quantitative targets to be met. Some of these targets are mandatory while others are projections.[236] This serves as the gauge against which the success of the plans is measured and each new FYP gives an overview of the results of the previous plan's achievements.[237]

In the interim the State Council is subject to making reports on the implementation of the plans and budgets to the Standing Committee of the NPC each year. The local people's governments at various levels are responsible to report their work to the people's congresses at the corresponding levels.[238] The report on developments during the first year of the 13th FYP

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[234] See 13th FYP, Chapter 80, Section 2.
[235] Ibid., Chapter 80, Section 3.
[236] Ibid., Chapter 3 - Major Objectives. See also Kennedy, S. and Johnson, K., (2016). *Perfecting China, Inc. The 13th Five-Year Plan* CSIC 2016, p. 25.
[237] See for instance 13th FYP, Chapter 1, Box 1 concerning the fulfilment of the main targets of the 12th FYP.
[238] For additional details, see: http://www.npc.gov.cn/englishnpc/about/2007-11/20/content_1373255.htm, accessed on 8 August 2017.

was presented to the National People's Congress in March 2017 by Li Keqiang.[239] In making these reports the targets and work program for the following year's priorities are also set out.

4.3.3. MOTIVATION TO IMPLEMENT FIVE YEAR PLANS

In addition to the formal mandatory nature of the plans stemming from relevant laws and from the wording of the plans themselves, another component contributes to the importance of the planning system in China, namely the motivation – of government officials and enterprises alike – to actually implement the plans.

In the case of industry, such motivation is apparent. Given that the plans lay down the government priorities, the regulatory and financial support will be primarily channelled into such selected priority sectors (see section 4.2.9). The Chinese businesses, state-owned as well as private, have therefore a strong incentive to align their activities with the priorities identified in the relevant plans, as being consistent with the plans is more likely to result in favourable treatment by the government authorities, typically in terms of market access or financial support.[240]

The role of the industry associations (see also Chapter 3.4.3) in the implementation of plans and industrial policies is set out in various plans. For example we see in the 13th FYP for the Non-ferrous metal industry, '*The industry's sectoral associations shall fully play their bridging and linking role, by guiding and supporting enterprises to fulfil their priority tasks and by formulating relevant policy suggestions.*'[241] A further example of this involvement of the industry associations in implementing plans and industrial policy as well as acting as a link between Government and industry is found in the ceramics section of the 13th FYP on light industry development which states that China shall, *'fully involve industry associations in their role as a bridge and a link between government and enterprises […]; support industry associations' efforts to deepen reforms, improve internal governance, raise capacities to serve the industry's development, strengthen investigation and research as regards the main problems related to the industry's development […]; guide and standardise enterprises' behaviour, strengthen the industry's self-discipline.*'[242]

At the same time, government officials have also a strong motivation to ensure appropriate plan implementation, since reviewing the effectiveness of plan implementation inevitably contains an element of assessing the performance of the local leaders who are in charge of the plan implementation. As it has been reported, not complying with the targets set by the relevant plans can result in a career advancement veto for the cadres concerned.[243]

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[239] See State Council Website. (2017). *Report on the Work of the Government*, http://english.gov.cn/premier/news/2017/03/16/content_281475597911192.htm (accessed on 16 October 2017).
[240] Kennedy, S. and Johnson, K. (2016). *Perfecting China, Inc. The 13th Five-Year Plan*. Washington, DC: CSIS, p. 4.
[241] See 13th FYP for the Non-ferrous metal industry, Section V.5.
[242] See 13th FYP on Light Industry Development, Section V.9.
[243] Melton, O. (2015). *China's Five-Year Planning System: Implications for the Reform Agenda*, p. 5.

4.3.4. PRACTICAL EXAMPLES OF FYP IMPLEMENTATION

A number of developments in China over the last years demonstrate that the Chinese system of plans has a marked influence on the activities of Chinese industry.

The development of the Chinese photovoltaic ('PV') sector is a good example of how the government-driven industrial policy led to a development of the industry. In 2005 China accounted for an insignificant portion of the global solar PV manufacturing, which then surged to around 50% in 2011 and 2012.[244] China's existing production capacity for solar panels was about 150% of global demand in 2012.[245] By the end of 2013, China accounted for 67% of global PV module production.[246] China's production during the durations of the 12th FYP was mainly export-oriented[247] and seven of the top 10 solar PV manufacturers worldwide were Chinese.[248] The government provided strong support to the solar PV industry using for example the means of cheap loans,[249] governmental investment into R&D,[250] preferential electricity,[251] preferential access to land,[252]etc. A very important development was

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[244] Chen, G. (2015). China's Solar PV Manufacturing and Subsidies from the Perspective of State Capitalism. *The Copenhagen Journal of Asian Studies* 33(1), pp. 90-105, page 95.

[245] Ibid.

[246] See REN21. (2014). *Renewables 2014 Global Status Report*. Paris: REN21 Secretariat, Page 48. Available at: http://www.ren21.net/Portals/0/documents/Resources/GSR/2014/GSR2014_full%20report_low%20res.pdf. In 2016, the share of China's PV module production was stabilised at 65% globally. See REN21, (2017), *Renewables 2017 Global Status Report*. Paris: REN21 Secretariat, Page 69.

[247] '[…] *the central government identified the PV industry as one of a number of key industries in the Catalog of Chinese High-Technology Products for Export updated in 2006. As a result, PV manufacturers were eligible for additional financial support for research and development and received export credits at preferential rates from the Import-Export Bank of China, as well as export guarantees and insurance through the China Export and Credit Insurance Corporation'*. See Zhang, S., Andrews-Speed, P, Ji, M., (2014) The erratic path of the low-carbon transition in China: Evolution of solar PV policy. *Energy Policy* 64, pp. 903-912. Page 907.

[248] Urban, F., Geall, S., Wang, Y. (2016). Solar PV and solar water heaters in China: Different pathways to low carbon energy. *Renewable and Sustainable Energy Reviews*, Vol. 64(2016): 531–542. Page 535.

[249] By August 2012, China's top ten PV makers accumulated a combined debt of USD 17.5 billion, see Chen, G. (2015). China's Solar PV Manufacturing and Subsidies from the Perspective of State Capitalism. *The Copenhagen Journal of Asian Studies* 33(1), pp. 90-105, page 97. Furthermore: '[…] the ability of the municipal government to encourage local state-owned banks to provide low interest loans to PV firms […] created a fund-raining and expansion boom in the Chinese PV industry, particularly in provinces such as Jiangsu.' In Urban, F., Geall, S., Wang, Y., 2016. Solar PV and solar water heaters in China: Different pathways to low carbon energy. *Renewable and Sustainable Energy Reviews*, Vol. 64(2016): 531–542. Page 537.

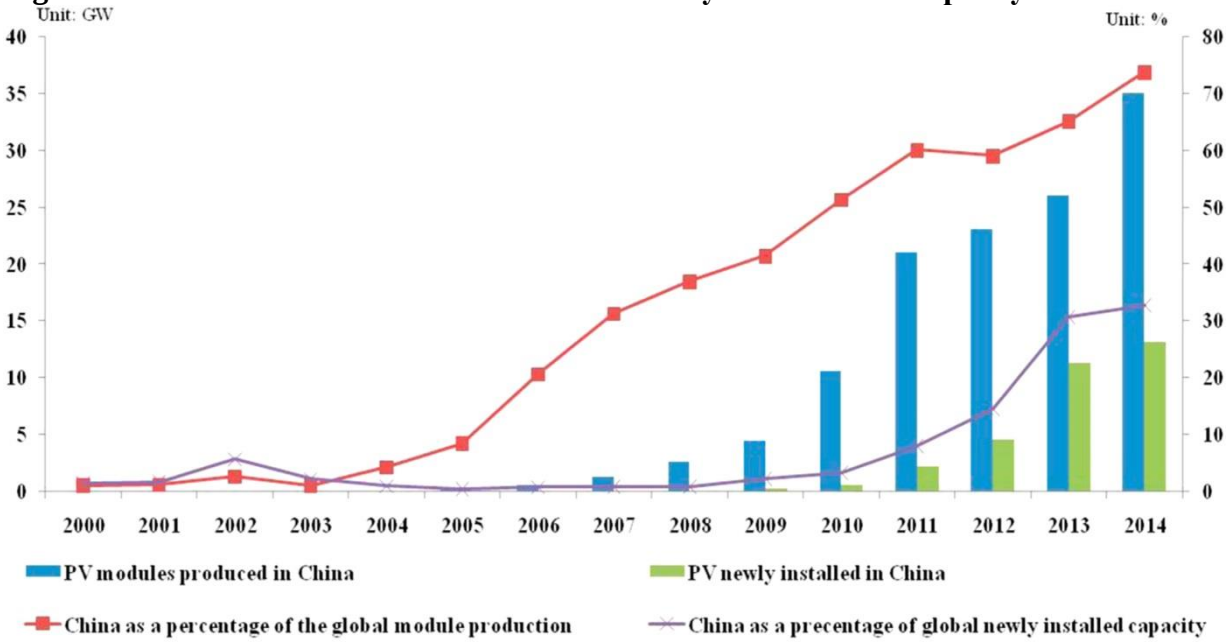
[250] '*The Ministry of Science and Technology (MOST) has driven forward PV R&D, with an average annual investment of around 500 million yuan (around USD 81 million) toward all segments of the manufacturing chain: Poly-silicon, wafer, solar cells, PV modules, thin-film technology, CPV, energy storage, BOS components and system engineering*' in Urban, F., Geall, S., Wang, Y., 2016. Solar PV and solar water heaters in China: Different pathways to low carbon energy. *Renewable and Sustainable Energy Reviews*, Vol. 64(2016): 531–542. Page 536.

[251] See findings in the Council Implementing Regulation (EU) No 1239/2013 of 2 December 2013 imposing a definitive countervailing duty on imports of crystalline silicon photovoltaic modules and key components (i.e. cells) originating in or consigned from the People's Republic of China. Para 348: '*The investigation established that many of the sampled exporting producers had a related polysilicon producer within their company group. It was found that one of the sampled groups of exporting producers, i.e. LDK Solar, received regularly significant electricity fee subsidies from the Financial Bureau of Xin Yu Economic Zone. […]. In fact, the company concerned in the LDK Group received a near total refund of its electricity fees due in the IP*.' Also in Chen, G. (2015). China's Solar PV Manufacturing and Subsidies from the Perspective of State Capitalism. *The*

the stimulus package of RMB 4 trillion for the period 2009-2010 announced in November 2008, which included allocations for additional incentives to the solar industry, thanks to which the production of PV cells increased 8.3 times, production of wafers increased 10 times, and production of polysilicon increased 18 times, leading to progressive overcapacity.[253]

Figure 1 illustrates the rapid growth in the PV sector in China.

Figure 1: China's PV Annual Production and Newly PV Installed Capacity.



Source: Zhang, F. and Gallagher, K.S. (2016). *Innovation and technology transfer through global value chains: Evidence from China's PV industry.* Energy Policy 94, pp 191-203. Page 193. Data in the table sourced from: IEA,2014. PVPS annual report 2013, IEA, 2015. PVPS annual report 2014, Li, J.F, et al. (2014). *Annual review and outlook for China solar PV industry 2013*. Chinese Renewable Energy Industry Association (CREIA).

This development can be linked to the governmental policy of supporting the PV industry, as set out in the 11th FYP (2006-2010), Renewable Energy Law (2005) and its amendment (2009) and the Medium- and Long-Term Development Plan for Renewable Energy (2007).[254]

Copenhagen Journal of Asian Studies 33(1), pp. 90-105, page 99: '*In response to the enormous energy appetite of LDK Solar, the state-owned power company in Xinyu City also built six transformer substations with a total capacity of 1,520,000 KVA (1,000 volt-amperes), equal to the capacity of the power grid in western Jiangxi Province, for the sole use of LDK Solar'*

[252] See Council Implementing Regulation (EU) No 1239/2013 of 2 December 2013 imposing a definitive countervailing duty on imports of crystalline silicon photovoltaic modules and key components (i.e. cells) originating in or consigned from the People's Republic of China. Paras 354-368, Chen, G. (2015). China's Solar PV Manufacturing and Subsidies from the Perspective of State Capitalism. *The Copenhagen Journal of Asian Studies* 33(1), pp. 90-105, page 98.

[253] Zhang, S., Andrews-Speed, P, Ji, M. (2014). The erratic path of the low-carbon transition in China: Evolution of solar PV policy. *Energy Policy* 64, pp. 903-912. page 908.

[254] Chen, G. (2015). China's Solar PV Manufacturing and Subsidies from the Perspective of State Capitalism. *The Copenhagen Journal of Asian Studies* 33(1), pp. 90-105, page 96.

The PV industry was not only included amongst the seven 'strategic' industries in the 12th FYP (2011-2015) under the new energy chapter, but a specific plan for the PV industry was elaborated in that context (12th FYP for the Solar Photovoltaic industry). In that plan the Government of China committed itself *'to promote the implementation of various photovoltaic support policies*'[255] and *'formulate overall preparation of supporting policies on industry, finance, taxation[…]'.*[256] In practical terms these plans have translated into very significant increases in capacity for PV in China. While capacity has been steadily growing in the last 10 years, '*it has more than doubled between 2012 and 2015 (from 43.8 GW in 2012 to 96.3 GW in 2015)'*.[257]

Another industry impacted by state planning is new energy vehicles ('NEV'). In 2012, The State Council issued a Plan on the Development of Energy-saving and New Energy Car Industry (2012-2020) which set targets for production of electric vehicles in China. The plan states that by 2015, there would be aggregated production and sales of 500 000 pure and plugged in electric vehicles, rising to over 5 million by 2020.[258] The Made in China 2025 plan confirms the importance of these targets by including New Energy Vehicles and Equipment among its ten strategic sectors. In that context, section 3.6.6 of the plan 'Energy Efficient and New Energy Automobiles' states: *'We will continue to support electric automobiles and fuel cell vehicles'.* Such objectives appear to have given rise to an explosive growth of production of electric vehicles - official statistics from the MIIT website show that: '*in 2014, the aggregated production of new energy vehicles reached 83 900 (x4 compared to last year)'*[259] and 'i*n 2015, the aggregated production of new energy vehicles reached 379 000 (x4 compared to last year)*'.[260]

According to the estimates by CRU, thanks to government intervention the sector is developing very rapidly and the Chinese NEV market has good chances of achieving its goal to have 5 million vehicles on the road by 2020 (See Figure 2):

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[255] 12th FYP for the Solar Photovoltaic Industry, Section III.ii.

[256] Ibid., Section VI.i. China also had clear development goals with regard to economic objectives and the enterprise structure: '*By 2015, in China there will be one PV enterprise with annual sales revenue exceeding RMB 100 billion, 3-5 PV enterprises with annual sales revenue exceeding RMB 50 billion, and 3-4 enterprises specializing in PV equipment manufacturing with annual sales revenue exceeding RMB 1 billion.*'. See 12th FYP for the Solar Photovoltaic Industry, Section 3-III.

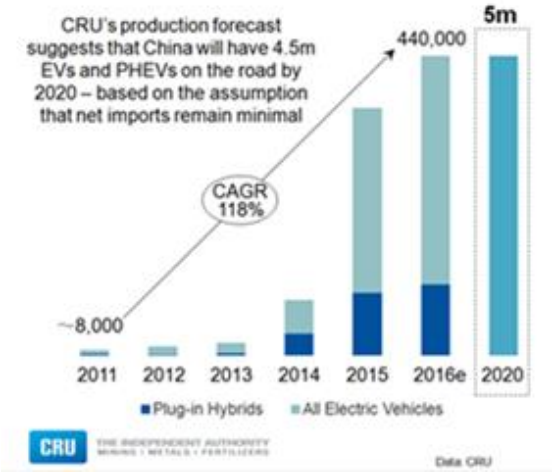
[257] Recital 595 Commission Implementing Regulation (EU) 2017/366 of 1 March 2017 imposing definitive countervailing duties on imports of crystalline silicon photovoltaic modules and key components (i.e. cells) originating in or consigned from the People's Republic of China following an expiry review pursuant to Article 18(2) of Regulation (EU) 2016/1037 of the European Parliament and of the Council and terminating the partial interim review investigation pursuant to Article 19(3) of Regulation (EU) 2016/1037.

[258] Plan on the development of energy-saving and new energy car industry, Section III-ii, available at: http://www.gov.cn/zwgk/2012-07/09/content_2179032.htm (accessed on 10 October 2017).

[259] MIIT website, 12 月新能源汽车产量突破 2.7 万辆, Available at: http://www.miit.gov.cn/n1146312/n1146904/n1648362/n1648363/c3488217/content.html (accessed on 13 December 2017).

[260] MIIT website, 2015 年 12 月新能源汽车产量达 10 万辆, Available at: http://www.miit.gov.cn/newweb/n1146312/n1146904/n1648362/n1648363/c4588273/content.html (accessed on 13 December 2013).

Figure 2: NEV production forecast



Source: CRU. (2016). *Cobalt's future in Chinese EVs*. Available at: https://www.crugroup.com/knowledge-and-insights/insights/cobalt-s-future-in-chinese-evs/ (accessed on 16 October 2017).

Even though China is in the process of reforming the excessive financial support policy for the NEV sector,[261] the support of the central and local governments which allowed for the sector to develop rapidly was substantial. For example, the support granted to the NEV sector in 2014 amounted to RMB 10 billion.[262] Also, existence of 'zombie' companies in the NEV sector shows that the rapid growth is not necessarily driven by demand.[263]

A further example of the impact of plans on manufacturing trends can be seen in the robotics sector. The 12th FYP for the High-end Equipment Manufacturing Industry (2011-2015) outlined a plan for overall revenue in the intelligent equipment sector to surpass RMB 1 trillion by 2015 and a target to produce 30% of intelligent equipment with domestic technologies.[264] China underlined furthermore its particular focus on robotics in 2015 in the Made in China 2025 plan, under the chapter 'High-end numerical control machinery and robotics'. The specific 13th FYP for the sector, the Robotic Industry Development Plan (2016-2020), sets an annual production target of 100 000 industrial robots using self-owned brands by 2020. According to a State Council website, *'special funds from the central budget will be*

[261] See for example Feng, E. and Clover, C. (2017). China puts a stop to electric-car gold rush, *Financial Times*, 27 June 2017, available at: https://www.ft.com/content/891d8264-5016-11e7-bfb8-997009366969 (accessed on 19 November 2017).
[262] Xinhua Finance. (2016). *China's new energy vehicle subsidies to become marketized*, 05/09/2016 available at: http://en.xfafinance.com/html/Industries/Consumer_Products_and_Services/2016/257416.shtml (accessed on 29/11/2017).
[263] South China Morning Post. (2017). *Is China's electric car dream turning into a zombie nightmare?* Available at: http://www.scmp.com/news/china/economy/article/2057439/chinas-electric-car-dream-turning-zombie-nightmare (accessed on 16 October 2017).
[264] China Daily., (2012). *Chinese robot wars set to erupt*. Available at: http://usa.chinadaily.com.cn/epaper/2012-12/06/content_15992180.htm (accessed on 16 October 2017).

earmarked to support robotics research and development, and financial institutions are encouraged to finance robotic projects'.[265]

The growth of the robotics industry in China is very rapid, especially considering that before 2008 there was almost no robotics industry in China.[266]

The industry benefits from governmental support,[267] which allowed for the creation of overcapacity. China itself recognises that as a problem – according to a State Council website:

> *China is highly alert of redundant construction and overcapacity risks in its robotics industry amid rapid development. [...] China now has more than 800 robotics enterprises, with some 72 400 industrial robots produced in 2016, up 34.3% year on year […] To avoid redundant construction, the ministry will strengthen government guidance for local authorities and robot producers in accordance with the country's "Made in China 2025" plan […] The ministry will also set strict and clear criteria for market entry to promote scientific and rational development of the robotics industry, […]. The country introduced the "Made in China 2025" blueprint in May 2015 to move its manufacturing sectors up the value chain, promoting development in 10 key sectors including robotics.*[268]

4.4. CHAPTER SUMMARY

The system of plans constitutes an important and sophisticated tool for the Chinese authorities to shape the economic and social life of the country. This holds true despite their complex structure sometimes combined with wording open to interpretation (see section 4.2.2. above).

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[265] See State Council website, *China to triple industrial robot production by 2020*, available at: http://english.gov.cn/state_council/ministries/2016/04/27/content_281475336534830.htm. (accessed on 16 October 2017). See also the Robotic Industry Development Plan (2016-2020), available at: http://www.ndrc.gov.cn/zcfb/zcfbghwb/201604/t20160427_799898.html (accessed on 16 October 2017).

[266] China Daily. (2014). *Over 30 robot factories under construction in China*, available at: http://www.chinadaily.com.cn/business/2014-10/27/content_18808711.htm (accessed on 16 October 2017).

[267] '*Chinese robot makers are to benefit from favourable government policies to help boost development […] The policies will include subsidies for companies who buy local brand robots, and a national merger and acquisition fund to help Chinese makers acquire world-advanced technologies from foreign companies […],industrial robot manufacturing is one of 10 key sectors that will benefit first from the newly released national plan Made in China 2025. Under the direct supervision of Premier Li Keqiang, it is designed to make breakthroughs in bottleneck areas so that the country can play an important role in global manufacturing.*' in China Daily, (2015). China to give robot makers subsidies and funding available at: http://www.chinadaily.com.cn/china/2015-09/16/content_21896671.htm (accessed on 16 October 2017). See also '[*China is] home to the world's fastest-growing robotics market and vast manufacturing sector where companies are under pressure to automate. […]. Guangdong province, for example, announced in 2015 plans to offer 943 billion yuan ($137 billion) in subsidies to about 2,000 local companies, including both robot makers and those making autos, home appliances, and construction materials, that are looking to automate their plants.*' In Bloomberg News. (2017). *Inside China's Plans for World Robot Domination*. Available at: https://www.bloomberg.com/news/articles/2017-04-24/resistance-is-futile-china-s-conquest-plan-for-robot-industry (accessed on 16 October 2017).

[268] See State Council website, *China 'highly alert' of overcapacity in robotics: regulator*, http://english.gov.cn/state_council/ministries/2017/03/11/content_281475591820951.htm (accessed on 16 October 2017).

Far from merely constituting a platform for possible government interventions into the economy, the planning system is more systemic, as the initially broader policy orientations of the higher level plans (see in particular section 4.2.7) are gradually fleshed out (see section 4.2.8) to the point of translating into individual projects receiving government support (see sections 4.2.9 and 4.2.10). The set of interventionist tools which the plans envisage to be employed by government bodies ranges from quantitative and qualitative development targets, production targets, and capacity control, to financial support, security of supply, interventions into the corporate structure of businesses, etc. (see section 4.2.9) and is mirrored by the pledge to encourage and support the sectors/areas/companies which the plans designate as priorities (see in particular section 4.2.7).

Plans are more than just strategic visions. Numerous provisions in laws and in the plans themselves attest to their binding nature. They determine the direction of the Chinese economy, set out priorities and prescribe the goals which all levels of government and emanations of the State must focus on and strive to implement. The objectives set by the plans are of a binding nature (see section 4.3.1) and the higher level authorities regularly control and monitor the progress of their fulfilment (see section 4.3.2).

Overall, the structure of the existing planning system, as well as substance of the current set of plans – the 13th FYPs at the respective levels of administration – suggests that, even though the FYPs, as well as the strategic initiatives, maintain the stated objective of allowing the markets to play a decisive role in resource allocation (see sections 4.2.3 and 4.2.7). The Chinese leadership continues to rely on a planning mechanism which strongly encourages the direction of resources towards sectors deemed to be strategic or emergent. Impact of plans is also manifest by the rapid growth seen in some sectors identified as strategic regardless of whether or not it results in overcapacities or 'zombie companies' (see section 4.3.4). Therefore, the planning system has a decisive impact on the economy, whereby the State fixes the conditions of competition based on public policy objectives.

5. STATE OWNED ENTERPRISES

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5.1. INTRODUCTION - SOES AND THEIR WEIGHT IN THE CHINESE ECONOMY

This chapter analyses the extent to which the Chinese market is served by enterprises which operate under the ownership, control or policy supervision or guidance of the Chinese authorities. The OECD defines an SOE as follows:

> [A]*ny corporate entity recognised by national law as an enterprise, and in which the state exercises ownership, should be considered as an SOE. This includes joint stock companies, limited liability companies and partnerships limited by shares. Moreover statutory corporations, with their legal personality established through specific legislation, should be considered as SOEs if their purpose and activities, or parts of their activities, are of a largely economic nature.*

Furthermore, the following companies are considered to be SOEs:

> […] *enterprises* […] *under the control of the state, either by the state being the ultimate beneficiary owner of the majority of voting shares or otherwise exercising an equivalent degree of control. Examples of an equivalent degree of control would include, for instance, cases where legal stipulations or corporate*

articles of association ensure continued state control over an enterprise or its board of directors in which it holds a minority stake.[269]

For the purpose of this report, the above OECD definition would be in line with the view of the Commission services that the notion of SOEs should encompass the effective exercise of control over the relevant entity[270] rather than looking only at formal ownership structure. However, this is not a generally accepted definition of SOEs in China. While the relevant Chinese legislation refers to '*state-invested enterprises*' and defines them as '*a wholly state-owned enterprise or company with the state being the sole investor, or a company in which the state has a stake, whether controlling or non-controlling*',[271] the official Chinese statistics are based on the categories of '*state-owned enterprises*' and '*state-holding enterprises*'.[272] In addition, the Chinese authorities also operate with the term '*state-controlled enterprises*' which encompasses enterprises with more than 50% state ownership, as well as those where the State has less than 50% ownership but more than other shareholders or those where the State owns less shares than other shareholders but obtains control through agreement.[273] This latter definition would come closest to the above OECD notion of SOEs as entities in which the State effectively exercises control.

Another level of complexity in delineating the precise extent of the state-owned and/or state-controlled sector stems from the fact that standard corporate metrics may '*fail to capture key aspects of Chinese corporate governance and industrial organization*'[274] since, in the Chinese economy, control is reportedly sometimes conferred not only via the ownership- or agreement-based channels but can originate from other, more informal arrangements. Such arrangements which have also been described as '*networked hierarchy*'[275] originate typically

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[269] See OECD. (2015). *Guidelines on Corporate Governance of State-Owned Enterprises*, p.14. Full version of the guidelines: http://www.oecd-ilibrary.org/governance/oecd-guidelines-on-corporate-governance-of-state-owned-enterprises-2015_9789264244160-en (accessed on 17 August 2017). It further refers to border line cases which need to be assessed on a case-by-case basis.

[270] See OECD. (2015). *Guidelines on Corporate Governance of State-Owned Enterprises*, p. 15.

[271] Law on the State-Owned Assets of Enterprises, Article 5 (see further section 5.2).

[272] See the China Statistical Yearbook (2016), in particular sections 1-7 and 1-8 including the explanatory notes after sections 1-8 and 13-15, http://www.stats.gov.cn/tjsj/ndsj/2016/indexeh.htm (accessed on 21 September 2017). The category 'state-owned enterprise' comprises '*non-corporation economic units where the entire assets are owned by the State*' whereas the category 'state-holding enterprises' refers to '*the original state-owned enterprises and state-holding enterprises. They are classified according to the actual investment made by the contrib[ut]or of state-owned part in the paid-in capital of the enterprises, or the degree of control or dominance of the contributor on the assets of the enterprises*.' The state holding enterprises can be absolute state-holdings (with the State in possession of more than 50% of the paid-in capital) or relative state-holding (with the State being the biggest shareholder but in not possessing more than 50% of the paid-in capital) or agreed state-holding (where the State has actual control over the enterprises according to agreements). see also OECD Working Group on Privatisation and Corporate Governance of State Owned Assets (2009) *State Owned Enterprises in China: Reviewing the Evidence* , http://www.oecd.org/corporate/ca/corporategovernanceofstate-ownedenterprises/42095493.pdf, p.5-6 (accessed on 21 September 2017).

[273] WTO Trade Policy Review China report - WT/TPR/S/342 (2016), p. 93, https://www.wto.org/english/tratop_e/tpr_e/s342_e.pdf (accessed on 9 October 2017)

[274] Lin, L. and Milhaupt, C. (2013). We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China. *Stanford Law Review* Vol. 65:697, p. 706 ff.

[275] Ibid.

in a dense network of connections and personal links between individual SOEs managers and political cadres which in turn are an expression of the Party exercising control over the economy.

Given the above limitations with respect to defining SOEs in China, as well as the lack of reliable figures in particular on the sub-central level of government, the following figures illustrating the importance of SOEs in the Chinese economy are estimates.[276] The assets of centrally controlled SOEs, industrial as well as non-industrial, are estimated to equal some USD 5.6 trillion worth of assets, with another USD 690 billion abroad[277] while the total assets of non-financial SOEs at central and sub-central level has been reported to exceed USD 16 trillion in 2013.[278] In terms of industrial sector only, according to the latest figures published by the IMF, Chinese SOEs account for 40% of total industrial corporate assets and for more than half of total corporate debt.[279] At the same time, the IMF estimates that SOEs produce less than 20% of China's industrial output.[280] This is in line with the findings of the 2016 World Trade Organisation ('WTO') trade policy review report, according to which in 2014, SOEs accounted for 22% of the share of industrial output. The 2016 annual report to Congress by the U.S.-China Economic and Security Review Commission,[281] relying on data collected in 2014, indicates that SOEs accounted for 38% of China's industrial assets with the contribution to the industrial output being between 25% and 30% on average. While in the past, in particular during the decade between mid-90ies and 2007, the overall presence of SOEs in the Chinese economy may have decreased,[282] IMF points out the recent growth in the size of the state-owned sector which this may result in crowding out private enterprises in a number of sectors.[283] At the same time, the WTO report also emphasizes that SOEs retain a significant share of the strategic sectors[284] where they effectively control the market by holding a share of

[276] Which are likely to underestimate the actual extent of government ownership in China as none of the above-mentioned SOE definitions captures all the complexities of the relevant ownership/control structures.
[277] Leutert, W. (2016). Challenges Ahead of China's Reform of State-Owned Enterprises. *Asia Policy* No. 21, p. 86.
[278] Using a 2013 exchange rate of RMB 6.1 per USD. See Shen, J. (2015). *SOE reform (I): Improving corporate governance*. Mizuho Economic Research report of 29 May 2015, p.3
[279] International Monetary Fund. (2017). *IMF Country report No. 17/247: The People's Republic of China – Article IV Consultation*, p. 15. https://www.imf.org/en/Publications/CR/Issues/2017/08/15/People-s-Republic-of-China-2017-Article-IV-Consultation-Press-Release-Staff-Report-and-45170 (accessed on 9 October 2017).
[280] International Monetary Fund. (2016). *Proactive Reforms Critical to China's Medium-Term Growth Prospects*. https://www.imf.org/en/News/Articles/2016/08/11/14/40/NA081216-Proactive-Reforms-Critical-to-China-Medium-Term-Growth-Prospects (accessed on 17 August 2017).
[281] U.S.-China Economic and Security Review Commission. (2016). *Annual report to Congress*, p. 92., https://www.uscc.gov/Annual_Reports/2016-annual-report-congress (accessed on 9 October 2017).
[282] See Naughton, B. (2016). *State Enterprise Reform: Missing In Action*. China Economic Quarterly June 2016. Gavekal Dragonomics, p. 15-16.
[283] International Monetary Fund. (2017). IMF Country report No. 17/247: *The People's Republic of China – Article IV Consultation*, p. 16.
[284] Defence, electricity generation and distribution, petroleum and petrochemicals, telecommunications, coal, civil aviation and waterway transport were designated as strategic sectors in 2006. See: e.g. Huanxin, Z. (2006). China names key industries for absolute state control (http://www.chinadaily.com.cn/china/2006-12/19/content_762056.htm, accessed on 17 November 2017). However, considering industrial sectors to have a higher or lower degree of strategic importance is a category evolving over time and it appears to vary also

80% - 90%.[285] It has been also pointed out that lately, SOEs are boosting presence in sectors of the modern services and technologies, considered of strategic importance by the government of China more recently (see Figure 3). Other methods of measuring the importance SOEs in the Chinese economy – such as e.g. income, profit and tax paid or proportion of total equity of all companies listed on the Shanghai and Shenzhen Stock Exchanges ('SZSE') – equally point to the important role of SOEs in China.[286] In addition to the overall extent of government ownership in China, SOEs also tend to be several time larger than private enterprises on the level of individual enterprises, irrespective whether the criterion used for such measuring is total assets, revenues or profits.[287]

The overall number of non-financial SOEs in China is estimated to exceed 150 000 (of which 52 000 are controlled by the central government, 42 000 by provincial, 16 000 by municipal and 45 000 by county level governments, respectively),[288] with an upward tendency since approximately 2010.[289] Available data suggest that even though SOEs at the sub-central level account for the majority of entities, assets and employees, the centrally controlled SOEs tend to be concentrated in strategic sectors where they have the task to represent China and deliver on industrial policy objectives.[290]

In terms of SOEs' overall presence in industrial sectors, according to OECD,[291] a large number of sectors are dominated or include a significant share of SOEs. This presence goes well beyond the strategic sectors mentioned above (for instance, in the construction sector, SOEs would account for less than 10% of companies present but for more than 35% of revenues).[292]

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depending on the political context (see e.g. the 2010 designation as Strategic Emerging Industries of the following sectors – clean energy, next-generation IT, biotechnology, high-end equipment manufacturing, new materials, clean energy vehicles). See more details in U.S.-China Economic and Security Review Commission (2016). *Annual report to Congress*, p. 100.

[285] See WTO Trade Policy Review China report - WT/TPR/S/342 (2016), p.96.

[286] Ibid.

[287] See the China Statistical Yearbook. (2016). sections 13-4 and 13-6 on the basis of the 'state-holding enterprises' used in the context of Chinese statistics (see above in footnote 272).

[288] Mizuho Securities Asia Ltd. (2015). *Mizuho Economic Research report of 24 November 2015*, p.1, 3.

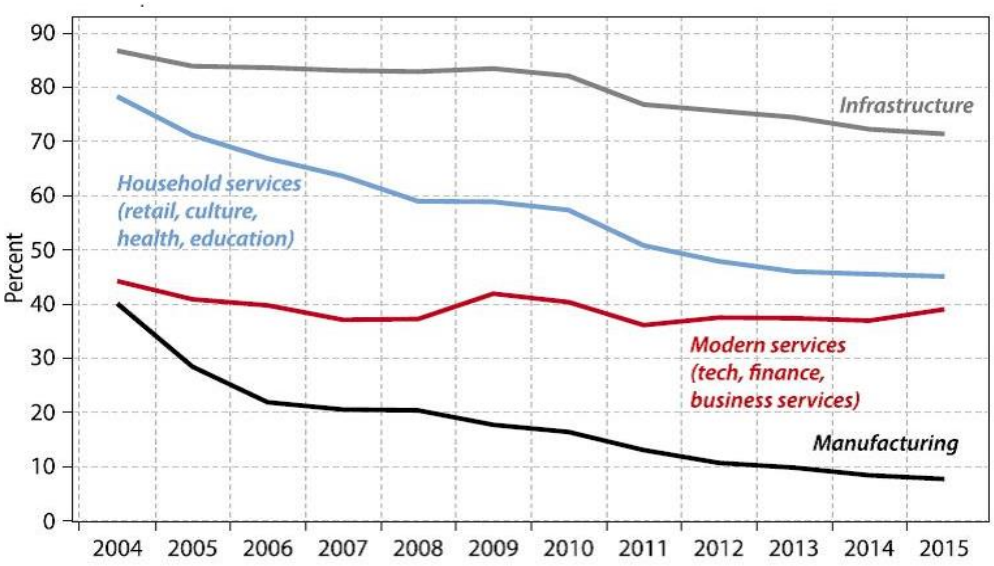
[289] See Butt, R. (2016). *China is walking itself into a trap*. Business Insider UK, http://uk.businessinsider.com/china-needs-to-reform-state-owned-enterprises-2016-9?r=US&IR=T (accessed on 13 March 2017).

[290] See Batson, A. (2017). *The State of the State Sector*. Gavekal Dragonomics, p. 9.

[291] OECD Economic Surveys. (2015). *China,Overview*; p. 34. http://www.oecd.org/eco/surveys/China-2015-overview.pdf (accessed on 10 October 2017)

[292] Ibid.

Figure 3: SOEs are increasing their presence in the modern service economy (State-owned enterprise share in fixed-asset investment, by sector group)



Source: See Batson, A. (2017). *The State of the State Sector*. Gavekal Dragonomics, p. 9.

The number of SOEs under direct supervision of central SASAC (see further in section 5.25.3) amounted to 98 in October 2017[293] and the Chinese state remains the majority shareholder in all but one of the 100 largest publicly listed Chinese companies.[294] According to the Fortune Global 500 list, three China based SOEs feature among the four largest companies in terms of revenue globally – State Grid Corporation of China, Sinopec Group and China National Petroleum Corporation as numbers two, three and four, respectively.[295] Similarly, the largest 500 companies in China are reported to have earned USD 9.2 trillion in 2013, of which 86% was earned by SOEs and only 14% by private companies.[296]

The substantial role which SOEs maintain in the Chinese economy as described above[297] gives the government an exceptionally favourable platform to exert control over the country's economy. Despite numerous announcements by the Chinese government at various points in

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[293] See the full list on the SASAC website: http://www.sasac.gov.cn/n2588035/n2641579/n2641645/index.html (accessed on 3 October 2017).

[294] See WTO Secretariat. (2016). *Trade policy review 2016: China*, 15 June 2016. p. 97; https://www.wto.org/english/tratop_e/tpr_e/s342_e.pdf (accessed on 20 November 2017)

[295] See Fortune Global 500, http://beta.fortune.com/global500/list (accessed on 10 October 2017). Furthermore, China Construction Bank takes the 22nd place on the list, China State Construction Engineering place 28, Agricultural Bank of China place 28, Bank of China place 42 and China Mobile Communications still makes it among the 50 largest companies on place 47.

[296] U.S.-China Economic and Security Review Commission. (2016). *Annual report to Congress*, p. 93.

[297] See also World Bank and the Development Research Center of the State Council, P. R. China., (2013). *China 2030: Building a Modern, Harmonious, and Creative Society*. Washington, DC: World Bank, p. 26; http://documents.worldbank.org/curated/en/781101468239669951/pdf/762990PUB0china0Box374372B00PUBLIC0.pdf (accessed on 10 October 2017). This report concedes that '*government ownership is widespread and varied, covering most sectors and ranging from outright ownership to controlling interest to minority shareholder*' (p. 26);

time that pro-market SOE reforms would be imminent, the recent developments in the relevant institutional and legal framework confirm rather the opposite tendency, namely to use SOEs to pursue other goals (e.g. strategic, social) instead of aligning the SOEs' conduct with market principles.

5.2. LEGAL AND INSTITUTIONAL FRAMEWORK

The general legal framework in which SOEs operate is set by Article 7 of the Constitution which stipulates that: '*the State-owned economy, namely, the socialist economy under 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.*' The Constitution therefore unequivocally ascribes a particular role to the state-owned sector (as opposed to e.g. the principle of ownership neutrality in the EU Treaties) for it to be the leading force of the economy (see also Chapter 2).

These basic constitutional principles are reiterated and elaborated on by the relevant secondary legislation,[298] in particular by the Company Law[299] and the Law on the State-Owned Assets of Enterprises[300] ('SOE Law'). According to Article 1 of the Company Law, one of the central objectives of the legislation is to '*safeguard the social and economic order and promote the development of the socialist market economy*'. This is further developed by the SOE Law, Article 1 of which stipulates that the main purpose of the law consists of '*safeguarding the basic economic system of China, consolidating and developing the state-owned economy, strengthening the protection of state-owned assets, giving play to the leading role of the state-owned economy in the national economy, and promoting the development of the socialist market economy.*' The idea of consolidation and strengthening of the state-owned sector is emphasized even more in Article 7 of SOE Law which mandates the State to:

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[298] According to Article 16 of the Constitution, http://www.npc.gov.cn/englishnpc/Constitution/node_2825.htm (accessed on 29 August 2017). '*State-owned enterprises have decision-making power with regard to their operation within the limits prescribed by law.*'

[299] Company Law of the People's Republic of China (Adopted at the 5th Session of the Standing Committee of the 8th National People's Congress on 29 December 1993. Revised for the first time on 25 December 1999 in accordance with the Decision of the 13th Session of the Standing Committee of the Ninth People's Congress on Amending the Company Law of the People's Republic of China. Revised for the second time on 28 August 2004 in accordance with the Decision of the 11th Session of the Standing Committee of the 10th National People's Congress of the People's Republic of China on Amending the Company Law of the People's Republic of China. Revised at the 18th Session of the 10th National People's Congress of the People's Republic of China on October 27, 2005. Revised for the third time on 28 December 2013 in accordance with the Decision on Amending Seven Laws Including the Marine Environment Protection Law of the People's Republic of China at the 6th Session of the Standing Committee of the 12th National People's Congress; promulgated on 28 December 2013): http://www.fdi.gov.cn/1800000121_39_4814_0_7.html#_Toc381707441 (accessed on 17 August 2017).

[300] Law of the People's Republic of China on the State-Owned Assets of Enterprises (Adopted at the 5th session of the Standing Committee of the 11th National People's Congress of the People's Republic of China on 28 October 2008 and promulgated on the same date): http://www.lawinfochina.com/display.aspx?lib=law&id=7195&CGid= (accessed on 17 August 2017).

> [...] *take measures to promote the centralisation of state-owned capital to the important industries and key fields that have bearings on the national economic lifeline and state security, optimize the layout and structure of the state-owned economy, promote the reform and development of state-owned enterprises, improve the overall quality of the state-owned economy, and strengthen the control force and influence of the state-owned economy.*

This clarification of the top-down relation of the State to the state-owned sectors is mirrored by Article 36 of SOE Law which stipulates that '*a state-invested enterprise*[301] *making investment shall comply with the national industrial policies* […]'.

The current system of state owned asset management formally entered into force in 2003 by means of a Decree of the State Council which promulgated the Interim Regulations on Supervision and Management of State-owned Assets of Enterprises, adopted at the Eighth Executive Meeting of the State Council on 13 May 2003 ('SASAC Regulation').[302] The overall objective of the SASAC Regulation, as provided for in Article 1 of the said Regulation is wider than just preserving the interest of the State as an investor. Article 1 specifies that the Regulation serves the main purpose to '*establish a State-owned assets supervision and management system that suits the needs of socialist market economy, better run State-owned enterprises, push forward the strategic adjustment to the layout and structure of the State economy*[303] *, develop and expand the State economy* […]'. Articles 5, 6 and 12 mirror the two layer (central and provincial) system of state-owned asset supervision and administration authorities, namely SASAC and local SASACs, that was already provided for in Article 11 SOE Law.

Furthermore, additional provisions of the SASAC Regulation confirm that the mission of the SASACs is to pursue industrial policy and other public policy objectives.[304] More specifically, Article 14 lays down the main SASAC obligations one of which is to '*maintain and improve the controlling power and competitive power of the State economy in areas which have a vital bearing on the lifeline of the national economy and State security, and improve the overall quality of the State economy.*' This obligation to shape the economic/competitive structure of selected sectors does not necessarily sit well with Article 7 which provides for a separation of government functions of social and public administration from the functions of investor on all levels of administration authorities: '*the State-owned*

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[301] The term 'state-invested enterprise' refers to a wholly state-owned enterprise or company with the State being the sole investor, or a company in which the State has a stake, whether controlling or non-controlling – see Article 5 of SOE Law.

[302] Decree of the State Council of the People's Republic of China No. 378 of 27 May 2003, http://en.sasac.gov.cn/n1408035/c1477199/content.html (accessed on 10 October 2017).

[303] Article 2 SASAC Regulation limits its applicability to the supervision and management of State-owned assets of State-owned enterprises, State-owned holding enterprises and enterprises with State-owned equity. Concerning the supervision and management of State-owned assets of financial institutions -which are outside the scope of the SASAC Regulation – see Chapter 6.

[304] Mattlin, M. (2007). *The Chinese government's new approach to ownership and financial control of strategic state-owned enterprises*. Helsinki: Bank of Finland, Institute for Economies in Transition, p. 10.

assets supervision and administration authority shall not perform the functions of social and public administration assumed by the government.' SASAC therefore represents a body which is ideally placed to pursue a wide range of government policies via SOEs and which has been actively participating in – and sometimes setting (see below in section 5.3) - the recent SOE reform agenda.

In 2017, the State Council further specified the role of SASAC in the Notice on Forwarding the Plan of the State-owned Assets Supervision and Administration Commission of the State Council on Promoting the Transformation of Functions by Primarily Focusing on Capital Management ('SASAC Notice').[305] The SASAC Notice calls for improving the regulation of planning and investment and states in this connection that:

> [i]*t is essential to follow national strategies and major decision-making, enforce national industrial policies and the overall requirements on the development of key industries, adjust and optimize the layout of State-owned capital, step up efforts of planning and guidance with regard to investment by central enterprises* […].[306]

With regard to the operation of state-owned capital, the SASAC Notice provides that it is vital to '*promote the optimal allocation of State-owned capital by centering around the missions of serving national strategic objectives'* and to '*encourage SOEs to pursue long-term benefits, and push State-owned capital to gravitate towards important sectors and key fields concerning national security, national economic lifeline and people's livelihood, key infrastructure, forward-looking strategic industries and enterprises with core competitive edges*'.[307]

The legal framework described above governing SOEs and its supervision and administrative authorities, i.e. the central and local SASACs, as well as some further authorities which are exercising jurisdiction over a particular set of SOEs – such as the MOF for SOEs in the sectors of financial and postal services or culture[308], sets up a system in which the SOEs, rather than acting according to commercial considerations, have to pursue a number of other objectives, such as complying with national industrial policies.

5.3. SOE REFORMS 2013 TO DATE – LACK OF MARKET-ORIENTED REFORM OF SOES

The 3rd Plenum Decision (see section 2.1.4) adopted on 12 November 2013 sets out the overall purpose of the reforms as to '*perfect and develop the socialist system with Chinese*

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[305] Notice on Forwarding the Plan of the State-owned Assets Supervision and Administration Commission of the State Council on Promoting the Transformation of Functions by Primarily Focusing on Capital Management, General Office of the State Council, Guo Ban Fa [2017] No. 38, promulgated on 27 April 2017.
[306] SASAC Notice, Point 2 (1).
[307] Ibid.
[308] OECD. (2017). *OECD Economic Surveys: China 2017*. OECD Publishing, Paris, p. 85; https://www.oecd.org/eco/surveys/china-2017-OECD-economic-survey-overview.pdf (accessed on 10 October 2017).

characteristics, and to modernize the system and ability to govern the country. We must pay more attention to the systemic, integrated, and coordinated nature of reform'. At the same time, the government's main role should be '*to maintain macro-economic stability, strengthen and optimize public services, guarantee fair competition, strengthen market's regulatory control, safeguard market order, promote a sustainable development, promote common prosperity, and make up for market malfunctions.*'

The above could suggest that the 3rd Plenum Decision calls for fundamental reforms in line with market principles. However, such conclusion is contradicted by section 2 of the 3rd Plenum Decision titled '*Uphold and Perfect the Basic Economic System'.* This section clearly prefers the State directed economic model by proclaiming that:

> *the basic economic system of keeping public ownership as the mainstay of the economy and allowing diverse forms of ownership to develop side by side is an important pillar of socialist system with Chinese characteristics, as well as the foundation of socialist market economic structure.* […] *We must steadfastly consolidate and develop the public sector of the economy, uphold the public sector as the key player, develop state-owned economy's dominant role, and constantly enhance state-owned economy's vigour, control, and influence.*

Moreover, far from invoking market principles, the 3rd Plenum Decision declares that:

> *state-owned capital investment and operation should serve the state strategic goals, and should be geared more to the important industries and crucial sectors vital to state security and the lifeline of national economy, primarily providing public services, developing the important forward-looking strategic industries, protecting the ecological environment, supporting scientific and technological progress, and protecting state security.*

The thrust of the 3rd Plenum Decision is therefore geared towards emphasizing the need to develop the dominant role of the state-owned economy with powerful SOEs where the State is heavily involved in the operational decisions. This thrust became even more apparent at the implementation stage when the SOE reform agenda outlined by the 3rd Plenum Decision was broken down into a number of initiatives[309] distributed among various authorities.[310] The Guiding Opinions of the CPC Central Committee and the State Council on Deepening the Reform of State-owned Enterprises ('Guiding Opinions'),[311] a document effectively prepared by the State Council Leading Small Group on State Enterprise Reform, headed by Vice-

[309] The entire 3rd Plenum Decision reforms entailed more than 300 initiatives of which 34 related to SOEs. SOE reforms were also announced in virtually all provinces. See Naughton, B. (2016). *State Enterprise Reform: Missing In Action*. China Economic Quarterly June 2016. Gavekal Dragonomics, p. 19. See further Mizuho Securities Asia Ltd. (2015). *Mizuho Economic Research report of 29 May 2015*, p.4
[310] SASAC, Ministry of Finance, NDRC etc.
[311] Guiding Opinions of the CPC Central Committee and the State Council on Deepening the Reform of State-owned Enterprises, Zhong Fa [2015] No.22, Adopted on 24 August 2015

Premier Ma Kai,[312] are particularly relevant. They first recall that '*the direction of socialist market economic reform shall be adhered to*' and that it is '*important to follow the rules and laws of market economy and enterprise development, make unwavering efforts to separate government from business, government from capital, and ownership from the right to business operations.*'[313] They also distinguish between two types of SOEs: those engaged in activities of a public welfare nature and commercial SOEs.[314] However, even with respect to commercial SOEs, that they seek to reinforce the role of state ownership and to use such ownership for strategic economic goals decoupled from market rules.[315] According to Article 5 of the Guiding Opinions:

> *Commercial SOEs whose core business belongs to major industries and key fields concerning national security or national economic lifeline, or that are mainly responsible for major special project tasks shall maintain the position of State-owned capital as the controlling shareholder* […]. *Special business segments shall be effectively separated from competitive business segments, and be independently run and accounted for. The assessment of such SOEs shall not only cover their business performance indicators and the preservation and appreciation of the value of their State-owned assets, but also focus on aspects such as their efforts to serve national strategies, safeguard national security and the operation of the national economy, develop cutting-edge strategic industries and complete special tasks.*

In the same vein, Article 14 of the Guiding Opinions stipulates that:

> *it is paramount to* […] *optimize the key investment directions and fields for State-owned capital by closely centering around the missions of serving national strategies,*[316] *and enforcing State industrial policies and the general requirements of adjusting the layout of key industries, and push State-owned capital to gravitate towards important sectors and key fields concerning national security, national economic lifeline and people's livelihood, key infrastructure, forward-looking strategic industries and enterprises with core competitive edges.*

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[312] Leading Small Group on State Enterprise Reform was seemingly established precisely to resolve the conflicting views on how to progress with the SOE reforms.
[313] See Guiding Opinions, point (2).
[314] Ibid., points (4)-(6).
[315] See in that respect also the 2006 Notice of the General Office of the State Council on Forwarding the Guiding Opinions of the SASAC about Promoting the Adjustment of State-owned Capital and the Reorganisation of State-owned Enterprises (Guo Ban Fa [2006], No. 97, 5 December 2006) which declares among its main objectives the goal to '*further promote state-owned capital to concentrate on major industries and key fields relating to national security and national economic lifelines (hereinafter referred to major industries and key fields), and accelerate the formation of a batch of predominant enterprises with independent intellectual property rights, famous brands and strong international competitiveness'.*
[316] See further Art. 5 of the Measures for the Supervision and Administration of Investment by Central Enterprises (Order [2017] No. 34, issued 7 January 2017), according to which '*the investment of central enterprises shall serve the national development strategy* […].'

Moreover, the Guiding Opinions leave no doubt about the strong role to be attributed to the CCP in the operation of SOEs. Article 24 stipulates that:

> *It is critical to unify the efforts to strengthen Party leadership with those to improve corporate governance, include the overall requirements on Party building into the articles of association of SOEs,* […], *allow members of a SOE's Party organization leadership* […] *to be included in the board of directors, the board of supervisors or the management through statutory procedures, and allow members of a SOE's board of directors, board of supervisors and management who are Party members* […] *to be included in the SOE's Party organization leadership. In principle, a SOE shall set the position of the chairman of the board of directors separately from the position of the general manager, and its Party secretary and chairman of the board of directors shall generally be served by the same person.*

The pursuit of non-market goals becomes further apparent in particular from a second set of Guiding Opinions, titled Guiding Opinions on the Functional Definition and Classification of State-owned Enterprises ('Classification GO').[317] The Classification GO develops the basic division of SOEs as referred to in the Guiding Opinions, namely the division between SOEs engaged in activities of a public welfare nature and commercial[318] SOEs.[319] The Classification GO also reiterate the subdivision of commercial SOEs into those active in sectors of sufficient competition and those whose core business belongs to major industries and key fields concerning national security or national economic lifeline, or that are mainly responsible for major special project tasks.[320] The Classification GO envisages a radically different approach with respect to development, regulation and responsibilities of each of these two types of commercial SOEs. SOEs in competitive sectors shall be '*supported and encouraged to develop industries with competitive edges, optimize the investment directions of State-owned capital, promote the transfer of State-owned property rights, promptly dispose of inefficient, ineffective and non-performing assets, and sharpen their market competitiveness*.' By contrast, SOEs in strategic sectors shall '*play an even bigger role in serving national macro-economic control, safeguarding national security and national economic operation, accomplishing special tasks and other aspects.*'

Similarly, SOEs in competitive sectors

> *shall focus on strengthening regulation at the group company level, effectively enforce and safeguard the lawful exercise of the rights to make material decisions, select and appoint personnel, distribute remunerations, etc. by the*

[317] Guiding Opinions on the Functional Definition and Classification of State-owned Enterprises, Adopted on 30 December 2015 by SASAC, MoF and NDRC.
[318] I.e. for-profit.
[319] See point (1) Classification GO.
[320] See point (5) Guiding Opinions – see also above – and points (2) – (4) Classification GO.

> *board of directors, ensure the business operation autonomy of the management, and actively promote the system of professional managers.*

This contrasts with SOEs in strategic sectors. SASACs are '*required to* […] *guide such enterprises to highlight their primary business and better serve major strategies and macro-control policies of the State.*' Last but not least, the appraisal of SOEs differs. In competitive sectors the appraisal '*shall focus on their operating performance indicators, their preservation and appreciation of the value of State-owned assets and their market competitiveness.*' In contrast, when it comes to SOEs in strategic areas, according to the Classification GO:

> *it is imperative to reasonably determine the weight given to operating performance indicators and the indicators of the preservation and appreciation of the value of State-owned assets during their appraisal, and strengthen appraisal in such aspects as their efforts to serve national strategies, safeguard national security and national economic operation, develop forward-looking strategic industries and accomplish special tasks.*

It follows from this that all SOEs are subject to government direction. Some of the language used in relation to SOEs in competitive sectors seems to be at first sight more 'market oriented'. However, and more importantly, the Classification GO also stipulate that such SOEs shall be '*supported and encouraged to develop industries with competitive edges'.* The reference to '*supported and encouraged*' amounts to an expression of the Government's long-term political intention to maintain a direct control over the SOEs also in the competitive sectors where large integrated Chinese SOEs are to play a leading role on the international stage and where the State would provide resources for such developments.

The Guiding Opinions demonstrate that almost two years after the adoption of the 3rd Plenum Decision, the tension between declaring the need for market based reforms while using SOEs as vehicles to pursue non-market goals persisted. At the same time, the Guiding Opinions and the Classification GO already indicated where the future focus of the government would be. Indeed, while SOEs may formally be subject to corporatisation (which should be finalized by the end of 2017),[321] the strategic, security-related, social and other objectives have prevailed over commercial considerations. According to the IMF, this resulted in continued state support to SOEs, lack of harder budget constraints, as well as absence of pressure to default and exit where market forces warrant.[322]

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[321] Following earlier government initiatives (in particular the State Council Guiding Opinions on SOE Corporate Governance, see section 5.5.2), the State Council confirmed in July 2017 that all central SOE's should complete restructuring to become limited liability and joint stock companies by the end of the year. See e.g. Hu, Y. and Zheng, X. (2017). Central SOEs reform will be done in 2017. *China Daily*, http://www.chinadaily.com.cn/china/2017-07/27/content_30261201.htm ,(accessed on 10 October 2017).

[322] International Monetary Fund. (2017). IMF Country report No. 17/247: *The People's Republic of China – Article IV Consultation*, p. 31.

5.4. PRACTICAL IMPLEMENTATION OF THE LEGAL FRAMEWORK – SOES ARE CONTROLLED BY THE CHINESE GOVERNMENT AND OPERATE AS A TOOL OF GOVERNMENT POLICIES

As outlined in the preceding section, SOEs, in practice, both in the strategic and in the competitive sectors, represent an important vehicle for pursuing industrial policies by the government. A pre-condition for this is effective control over the conduct of SOEs which the Chinese government exercises by a number of means.

5.5. GOVERNMENT CONTROL OVER SOES

5.5.1. GOVERNMENT CONTROL OVER SOES' CORPORATE STRUCTURE – FEWER BUT BIGGER SOES

First of all, the government directly shapes the respective sectors' competitive landscape in order to achieve strategic economic goals. Some key sectors are even kept under full state control simply by means of regulatory prohibition for non-state companies to enter. SASAC's 2015 provisional list of SOEs in sectors where absolute state control should be maintained featured the following enterprises: China North Industries Group; China Grain Reserves; China National Petroleum; Sinopec Group; China National Offshore Oil; China Telecom Group; China Mobile Group; and China United Network Communications Group. [323] According to the 2015 Opinions of the State Council on the Development of Mixed Ownership Economy by State-owned Enterprises, SOEs '*in commercial category with main business in significant industries and key fields relating to the national security or the lifeline of the national economy, or state-owned enterprises in commercial category mainly undertaking major special projects shall maintain the controlling position of state-owned capital* […]'.[324]

Second, according to the State Council: '*China will speed up the regrouping of central State-owned enterprises to further reform and develop them*.' [325] As pointed out by a SASAC source '*to judge the regrouping of central SOEs, one must have a global and national strategic view on whether it will increase the international competitiveness of Chinese enterprises, safeguard the security of national industries and people's livelihoods, and protect the environment for the development of small and medium-sized enterprises.*' In other words, the mergers/consolidation aim at regrouping the central SOEs '*to 80 pro-innovation and*

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[323] See Mizuho Securities Asia Ltd. (2015). *Mizuho Economic Research report of 5 June 2015*, p.4.
[324] See the Opinions of the State Council on the Development of Mixed Ownership Economy by State-owned Enterprises, Guo Fa [2015] No.54, issued on 23 September 2015, point II.4.
[325] *China to further regroup central State-owned enterprises* (2016); http://english.gov.cn/policies/policy_watch/2016/08/23/content_281475423704259.htm (accessed on 14 March 2017). See also European Union Chamber of Commerce in China (2017). *China Manufacturing 2025, putting industrial policy ahead of market forces*, p. 19; http://www.europeanchamber.com.cn/en/publications-archive/473/China_Manufacturing_2025_Putting_Industrial_Policy_Ahead_of_Market_Force (accessed on 10 October 2017).

international-competitive "national enterprises"'[326]. Corresponding government regulations are in place since longer time already: the 2010 Opinions of the State Council on Promoting Enterprise Merger and Restructuring)[327] were followed in 2013 by the Guiding Opinions on Accelerating the Promotion of Mergers and Reorganizations of Enterprises in Key Industries ('Mergers GO'),[328]and in 2014 by the Directive on optimizing the corporate structure by restructuring the market environment, which promotes mergers of SOEs.[329]

In line with the abovementioned statements by the State Council and SASAC, the Mergers GO stipulate[330] that

> *Through promoting enterprises' mergers and reorganisation, [the aims and tasks are]*
>
> *-to raise the industry concentration level,*
>
> *-to foster scaling up,*
>
> *-to intensify operations,*
>
> *-to raise market competitiveness,*
>
> *-to foster a number of large enterprise groups that are competitive at international level,*
>
> *-to foster the industry's structural optimisation and upgrading;(…)*
>
> *[goals are:]*
>
> *- Speed up the strategic adjustment of the state-owned economy's arrangements and structures,*
>
> *- foster the development of the non-public economy and of SMEs,*

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[326] *China to further regroup central State-owned enterprises* (2016); http://english.gov.cn/policies/policy_watch/2016/08/23/content_281475423704259.htm (accessed on 14 March 2017). See also European Union Chamber of Commerce in China (2017). *China Manufacturing 2025, putting industrial policy ahead of market forces*, p. 19; http://www.europeanchamber.com.cn/en/publications-archive/473/China_Manufacturing_2025_Putting_Industrial_Policy_Ahead_of_Market_Force (accessed on 10 October 2017).

[327] Opinions of the State Council on Promoting Enterprise Merger and Restructuring [GuoFa, No.27 [2010] issued on 28 August 2010]; http://www.lawinfochina.com/Display.aspx?lib=law&Cgid=137472 (accessed on 20 November 2017).

[328] See http://www.miit.gov.cn/n1146285/n1146352/n3054355/n3057292/n3057306/c3574657/content.html, Gong Xin Bu Lian Chan Ye [2013] No. 16, (accessed on 19 September 2017). The Mergers GO spell out the official policy to undertake industrial concentrations of domestically-invested companies in selected sectors, such as automotive, steel, cement, shipbuilding, electrolytic aluminium, rare earths, electronic information, pharmaceuticals or agriculture industries.

[329] See http://www.gov.cn/zhengce/content/2014-03/24/content_8721.htm, Zhong Fa: 2014 No. 14, Promulgated on 7 March 2014 (accessed on 17 August 2017).

[330] See Main Objectives and main tasks' of the Mergers GO, Chapter 2 (emphasis added).

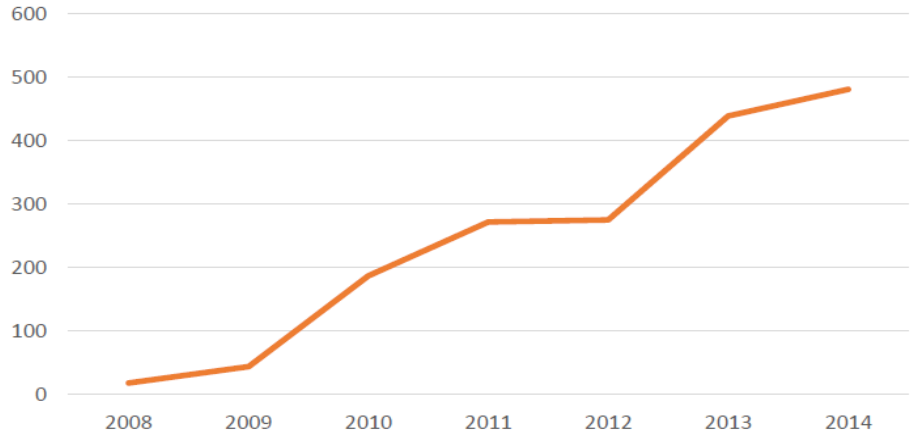
- improve the economic fundamental system allowing the development of the public ownership economy as a pillar together with the development of the diversified ownership economy. (emphasis added)

The consolidation plans resulted in a growing number of SOE restructurings[331] (see Figure 4) in recent years, including a series of SOEs mega-mergers, such as for instance between the railway vehicle manufacturers China North Locomotive & Rolling Stock Industry and China South Locomotive & Rolling Stock in 2014,[332] between the shipping groups COSCO and China Shipping in 2015,[333] between the steel producers Baosteel Group Corp. and Wuhan Iron & Steel Group Corp. in 2016,[334] between the textile equipment maker China Hi-Tech Group Corp. and China National Machinery Industry Corp in 2017[335]or between the mining conglomerates China Metallurgical Group Corporation and China Minmetals Corporation in 2015.[336] Streamlining the structure of existing SOEs into large industrial groups facilitates in turn the state's goal of '*exerting control and implementing development policies through the networks organized around the core companies*'.[337] The Chinese Antimonopoly Law ('AML')[338] makes it theoretically possible for this type of merger to be exempted from the standard merger control. This follows from Article 22(2) AML according to which a merger where '*one business operator who is not a party to the concentration has the power to exercise more than half the voting rights of every business operator concerned*' does not need to be declared to the Anti-monopoly Authority. In recent practice, mergers among SOEs are nevertheless regularly notified to MOFCOM. However, according to available information, these mergers are cleared unconditionally.[339] It is worthwhile noting that the State Council

[331] The restructuring process is facilitated by the ongoing corporatisation of SOEs.
[332] See Zhong, N. (2014). Two Railway Giants Announce Merger. *China Daily*; http://www.chinadaily.com.cn/business/2014-12/31/content_19206058.htm (accessed on 14 March 2017). See also Mizuho Securities Asia Ltd (2015). *Mizuho Economic Research report of 5 June 2015*.
[333] See Tian, S. (2015). China Approves Shipping Giants' Merger. *Xinhua*; http://news.xinhuanet.com/english/2015-12/11/c_134907868.htm (accessed on 14 March 2017); See also European Union Chamber of Commerce in China (2017). *China Manufacturing 2025, putting industrial policy ahead of market forces*, p. 19.
[334] See Wu, Y. and Yang, Z. (2016). Big merger forms No 2 steel giant. *China Daily*; http://usa.chinadaily.com.cn/business/2016-12/02/content_27545506.htm (accessed on 14 March 2017). Further SOE mergers have been recently seen e.g. in the energy, food and agriculture or construction sectors.
[335] See Feng, C. (2017). Machinery Giants Merge as Industry Reform Plow Ahead. *CaixinGlobal*; http://www.caixinglobal.com/2017-07-03/101109351.html (accessed on 5 October 2017).
[336] See for example Hornby, L. (2015). Beijing orchestrates mining merger between Minmetals and MCC, *Financial Times*. https://www.ft.com/content/6df65a0a-9d99-11e5-8ce1-f6219b685d74, (accessed on 20 November 2017).
[337] Lin, L. and Milhaupt, C. (2013). We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China. *Stanford Law Review* Vol. 65:697, p. 730.
[338] Anti-monopoly Law of the People's Republic of China, adopted at the 29th Meeting of the Standing Committee of the Tenth National People's Congress on August 30, 2007; http://www.china.org.cn/government/laws/2009-02/10/content_17254169.htm (accessed on 10 October 2017).
[339] See for example the MOFCOM webpage concerning the Baosteel Group Corp. and Wuhan Iron & Steel Group Corp (entry no. 53) http://fldj.mofcom.gov.cn/article/zcfb/201701/20170102495842.shtml (accessed on 6 December 2017). See further MLex. (2016). *Chinese SOEs face few antitrust hurdles as wave of state-led M&A continues*; *MLex market insight*. 27 July 2016.

emphasized in 2016 the fact that '*the regrouping is not a simple reduction of the number of central SOEs as their assets expanded seven times during the past 13 years*.'[340]

Figure 4: Mergers of State-owned Enterprises



Source: Meissner, M., Shih, L., Kinzius, L. and Heep, S. (2015). *Like a phoenix from the ashes: reforms are to bolster China's state-owned enterprises.* MERICS Web-Special, p. 8. https://www.merics.org/en/merics-analysis/archiv/dossierweb-special/web-specials1/ (accessed on 10 October 2017)

5.5.2. GOVERNMENT AND CCP CONTROL OVER SOES' PERSONNEL

A second channel of Chinese government's control over SOEs is the persisting influence over appointments of key management personnel, as well as the ever stronger presence of the Communist party organizations in SOEs.

Article 12 of the SOE Law specifies that '*a body performing the contributor's functions on behalf of the corresponding people's government shall enjoy the return on assets, participation in major decision-making, selection of managers and other contributor's rights to the state-invested enterprises according to law*.' Article 22 of the SOE Law spells out the role of such bodies in relation to senior staff of SOEs:

> *A body performing the contributor's functions shall, according to laws, administrative regulations and enterprise bylaws, appoint or remove, or suggest the appointment or removal of the following personnel of a state-invested enterprise: (1) Appointing and removing the president, vice-presidents, person in charge of finance and other senior managers of a wholly state-owned enterprise; (2) Appointing and removing the chairman and vice-chairmen of the board of directors, directors, chairman of the board of supervisors, and supervisors of a wholly state-owned company* […].

[340] See State Council website. (2016). *China to further regroup central State-owned enterprises*; http://english.gov.cn/policies/policy_watch/2016/08/23/content_281475423704259.htm (accessed on 14 March 2017).

With respect to appointing management of SOEs, the applicable law entrusts SASAC and local SASACs with competences which effectively ensure control over the composition of the companies' statutory bodies, including Articles 12 and 22 SOE Law as described in section 5.2 as well as Art. 13 SASAC Regulation according to which '*appoint or remove the responsible persons of the invested enterprises and evaluate their performance in accordance with the statutory procedures, and grant rewards or impose punishments based on the evaluation results*'[341] is one of SASAC's main responsibilities. Moreover, the State Council Guiding Opinions on SOE Corporate Governance ('Corporate Governance GO') from April 2017[342] contain a direct mandate for the Party to set the procedures and recommend candidates for SOE managers formally appointed by the boards of directors.[343] At the same time, '*the secretary of the Party group (Party committee) and the chairman of the board of directors shall in general be the same person and further work shall be done for the full-time deputy secretary to join the board of directors*'.[344] The Corporate Governance GO therefore effectively confer on the Party the power to exercise significant influence within the SOE's central decision making body, as well as to nominate the SOE's management. This is what the Guidelines describe as: '*inherent combination of the principle of cadre management by the Party with the selection and appointment of managers by the board of directors*' or '*leadership system of bi-directional entry and cross holding of posts*'.[345]

In practice, the Communist Party's Central Organisation Department[346] appoints top executives of some 50 core SOEs. These top managers enjoy a standing equivalent to political elites of the same rank, such as that of a vice provincial party secretaries or a vice-minister, in some cases even a minister.[347] The top management of the remaining central SOEs is nominated by SASAC in coordination with the Central Organisation Department[348] (see also section 3.3). Effectively, this system can amount to government officials being appointed SOE managers and/or board members and, conversely, SOE managers returning back to take up government functions.[349]

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[341] See SASAC Regulation, Art. 13 (4).
[342] Guiding Opinions of the General Office of the State Council on Further Improving the Corporate Governance Structure of State-owned Enterprises (promulgated on 24 April 2017; Guo Ban Fa [2017] No. 36).
[343] Corporate Governance GO, Article II.5.(3).
[344] Ibid.
[345] Ibid.
[346] The party organ entrusted with management of elite cadres.
[347] Leutert, W. (2016). Challenges Ahead of China's Reform of State-Owned Enterprises. *Asia Policy* No. 21, p. 87.; Lawrence, S. and Martin, M., (2013). *Understanding China's Political System.* Congressional Research Service, p. 16; https://fas.org/sgp/crs/row/R41007.pdf (accessed on 10 October 2017); OECD (2017). *OECD Economic Surveys: China 2017*, OECD Publishing, Paris, p. 88
[348] Leutert, W. (2016). Challenges Ahead of China's Reform of State-Owned Enterprises. *Asia Policy* No. 21, p. 91; OECD, (2017). *OECD Economic Surveys: China 2017*, OECD Publishing, Paris, p. 88.
[349] See Kratz, A. (2013). Reforming China' State-owned Enterprises, *China perspectives*, no. 2013/1. For instance, it has been reported that in 2012 that among 183 upper-echelon employees (deputy-minister and above) in 19 Ministries and Commissions, 56 have had experience in managing an SOE. Specific examples of this system entail for instance consecutive top managerial position of one individual at the Chalco/Chinalco conglomerate and at SASAC (see Komesaroff, M. (2016). Return of the Line Ministries, *China Economic*

The SASAC Notice summarises the system of controlling the SOEs' personnel as follows:

> *The principle of Party governance over cadres shall always be combined with market-oriented mechanisms. It is necessary to safeguard the Party's leadership over the personnel work of cadres and its right to manage important cadres, and strictly adhere to the criteria of loyalty to the Party, boldness in innovation, competency in corporate governance and enterprise development and upright and clean characters in selecting and appointing SOE leaders. The Party organizations of SOEs shall tighten control in terms of determining criteria, standardizing procedures, participating in assessment, recommending candidates, etc., manage managerial members in accordance with the laws of the market, establish a scientific and reasonable appraisal and evaluation system, and set a clear orientation of positive incentives for SOE leaders.*[350]

Such formal set-up not only ensures effective control of government agencies over SOEs, it also solidifies and reinforces the manifold informal ties between the State and its enterprises – ties the importance of which cannot be emphasized enough and which sometimes entail unexpected consequences. For instance, in the majority of cases, it is unlikely that the SOEs' statutory bodies oppose management nominations or any other intervention by the government with the SOEs' business given that the government officials serving as members of such bodies will normally not oppose any decision effectively imposed by their superiors within the government.[351] However, given the importance of rank within the Chinese administrative hierarchy, where the top-executive level of an SOE outranks the officials of the corresponding political level (typically at provincial level), the respective authorities may find it difficult to subject SOEs to their policies. In addition, such environment is conducive to corruption by individuals holding managerial positions in SOEs – the recent round of anticorruption campaign in China[352] and the government's attempts to put in place at least some additional controlling mechanisms (including increased rotation of executives[353] or the process of increasing personal accountability of managers)[354] to curb such undesirable behaviour being a proof.

Quarterly, Vol. 20 No. 2. Gavekal Dragonomics) or sequences of government posts and managerial positions in a number of energy SOEs held by close relatives of other high ranking government officials (see Hornby, L. (2017). China's consolidation push turns to sprawling power sector. *Financial Times*; https://www.ft.com/content/50614ed4-4c69-11e7-919a-1e14ce4af89b (accessed on 16 June 2017). For further examples of rotation of cadres between SOEs see e.g. The Economist (2012). State Capitalism is Not All the Same, http://www.economist.com/node/21542924 (accessed on 20 November 2017).

[350] See SASAC Notice, Point 2 (5).

[351] Mizuho Securities Asia Ltd. (2015). *Mizuho Economic Research report of 29 May 2015*, p.4-5.

[352] Leutert, W. (2016). Challenges Ahead of China's Reform of State-Owned Enterprises. *Asia Policy* No. 21, p. 93; Naughton, B. (2016). State Enterprise Reform: Missing In Action. *China Economic Quarterly* June 2016. Gavekal Dragonomics.

[353] Leutert, W. (2016). Challenges Ahead of China's Reform of State-Owned Enterprises. *Asia Policy* No. 21, p. 93

[354] According to the State Council, between 2017 and 2020 a system should be put in place in which management personnel at SOEs will be held responsible for loss of State assets or other serious consequences if

As for supervision by SASAC over SOE leaders after they are appointed, the Classification GO provides with respect to commercial SOEs:

> *The regulation of their State-owned assets shall be strengthened by primarily focusing on capital regulation, with emphasis being placed on effectively managing the layout of State-owned capital and making efforts to raise the return, standardize the operation, and safeguard the security, of State-owned capital. It is imperative to establish and improve supervision institutions and mechanisms, disclose information pursuant to laws and regulations, strictly pursue accountability, and prevent the loss of State-owned assets during reform and development. Specifically, commercial SOEs whose primary business belongs to industries and fields of sufficient competition shall focus on strengthening regulation at the group company level, effectively enforce and safeguard the lawful exercise of the rights to make material decisions, select and appoint personnel, distribute remunerations, etc. by the board of directors, ensure the business operation autonomy of the management, and actively promote the system of professional managers.*[355]

However, with regard to 'commercial SOEs whose primary business belongs to major industries and key fields concerning national security or national economic lifeline, or that are mainly responsible for major special project tasks':

> *It is required to focus efforts on strengthening the regulation of the layout of State-owned capital, and guide such enterprises to highlight their primary business and better serve major strategies and macro-control policies of the State.*[356]

In sum, as concluded by the World Bank, in China, SOEs' management and government officials usually support each other - management often accepts informal guidance from government officials and, in return, state enterprises are more likely to enjoy preferential access to bank finance and other important inputs, privileged access to business opportunities, and even protection against competition. This discourages new private sector entrants and reduces competition and innovation.[357]

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they fail to or incorrectly perform their duties, and they will continue to be accountable even after they are transferred to other positions or retire. See *China to set up accountability system for SOEs* (2016); http://english.gov.cn/policies/latest_releases/2016/08/23/content_281475424065504.htm (accessed on 21 March 2017).

[355] Classification GO, Section 2 (3).

[356] Ibid.

[357] World Bank and the Development Research Center of the State Council, P. R. China. (2013). *China 2030: Building a Modern, Harmonious, and Creative Society*. Washington, DC: World Bank, p. 26.

5.5.3. GOVERNMENT CONTROL OVER SOEs VIA THE PARTY AND ITS LOCAL ORGANISATIONS

In addition to controlling SOEs through direct ownership and through appointing the management personnel, the Communist Party's general claim to leadership, as well as its organizations in individual enterprises (see section 3.4.1), represent a third channel which state authorities employ to exercise their influence over the activities of SOEs. President Xi is reported to have reiterated the importance of the Party's leadership, as well as the need to strengthen the position of existing SOEs shortly after the adoption of the Guiding Opinions in 2015.[358] A year later, in October 2016, he reiterated at a meeting in which both senior government officials and SOE executives participated that '*Party leadership and building the role of the party are the root and soul for state-owned enterprises.* […] *The Party's leadership in state-owned enterprises is a major political principle, and that principle must be insisted on.* […] *The weakening, fading, blurring or marginalisation of Party leadership in state firms will no longer be tolerated.*'[359] In his view, '*SOEs as an important material and political basis for socialism with Chinese characteristics and an important pillar and reliable force for the CPC's governance of the country'* and 'CPC*'s leadership in SOEs is a major political principle which must be insisted on.* '[360]

The formal framework for the Party's role, within which further specific implementing actions can take place, is once again provided by the existing measures, such as Article 19 of the Company Law (according to which '[i]*n a company, an organization of the Communist Party of China shall be established to carry out the activities of the party* […]*. The company shall provide the necessary conditions for the activities of the party organization.*'), Article 33 of CCP Constitution (see Chapter 3), as well as Article 24 of the Guiding Opinions (see section 5.3).

However, the process of strengthening the party-building work in the state-owned sector - by enhancing the role of the party committees embedded in SOEs – found its most specific expression in the Corporate Governance GO. This has been widely reported previously.[361] Article I(2) of the Corporate Governance GO lays down the basic principles, among which features also the leadership by the Party. According to this principle:

> *it is imperative to* […] *unify the strengthening of the Party's leadership with the improvement of corporate governance, specify the legal status of the Party's*

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[358] Mizuho Securities Asia Ltd. (2015). *Mizuho Economic Research report of 24 November 2015*, p.1.
[359] Feng, E. (2016). Xi Jinping Reminds China's State Companies of Who's the Boss. *New York Times*; https://www.nytimes.com/2016/10/14/world/asia/china-soe-state-owned-enterprises.html?_r=2 (accessed on 11 April 2017).
[360] Xinhua. (2016). *Xi stresses CPC leadership of state-owned enterprises* http://news.xinhuanet.com/english/2016-10/11/c_135746608.htm (accessed on 10 October 2017).
[361] European Union Chamber of Commerce in China (2017). *China Manufacturing 2025, putting industrial policy ahead of market forces*, p. 19-20.; Hornby, L. (2016). *China rows back on state-sector reform*, Financial Times; https://www.ft.com/content/92e52600-31f7-11e6-ad39-3fee5ffe5b5b (accessed on 23 March 2017); U.S.-China Economic and Security Review Commission (2016). *Annual report to Congress*, p. 92.

> *organization of the State-owned enterprises in the corporate governance structure, bring into play the leadership core role and political core role of the Party's organization in the State-owned enterprises and ensure that the Party's organization determines the direction, manages the overall situation and guarantees the implementation.*

Subsequently, in Section II, the Corporate Governance GO call for standardization of subject rights and responsibilities with respect to SOE governance. Party organizations are considered to be one of the relevant SOE corporate governance subjects, along with the board of shareholders, board of directors, management, board of supervisors or the staff representative assembly. Article 5(1) stipulates: '*Sticking to Party's leadership and strengthening Party's construction are the unique advantages of State-owned enterprises.*' Moreover:

> *the legal status of the Party's organization in the corporate governance structure of the State-owned enterprises shall be specified, the overall requirement of the Party construction work shall be included in the articles of association of State-owned enterprises and rights, responsibilities and work method of Party organization in decision-making, execution and supervision shall be specified to make Party organization an integral part of corporate governance structure of enterprises. The role of Party organization as the leadership core and political core shall be brought into full play to* […] *support the performance of duties by the board of directors, board of supervisors and the management in accordance with the law and guarantee the implementation of guidelines and policies of the Party and the State.*

The SASAC notice contains very similar language:

> *It is required to clarify and enforce the statutory status of Party organizations in the corporate governance structures of SOEs, include the overall requirements on Party building into the articles of association of companies, fine-tune the rules and procedures for Party organizations to participate in the decision-making of major issues, and enable Party organizations to play their role in an organized, institutionalized and concrete manner; and, properly handle the relationship between Party organizations and other governance parties, make clear the boundaries of power and responsibility, and achieve seamless convergence*.[362]

According to available information, the ever stronger CCP presence in managing the SOEs' affairs envisaged by the Corporate Governance GO is since recently indeed being formalized at company level by referring to the leading role of the Party in the respective Articles of Association of various SOEs,[363] as well as privately owned companies or joint-ventures

[362] See SASAC Notice, point 2 (5).
[363] Including enterprises like Sinopec or the China Railway Group, as well as state-owned banks (See Section 3.4).

between SOEs and a private entity[364]. Such changes would entail language on the *'organised, institutionalised and concrete way*' in which CCP should play a role in an SOE, as well an on *'providing direction* [and] *managing the overall situation*'.[365]

5.5.4. SOEs as vehicles to pursue Government economic policies

The most recent developments in China show that the latest round of SOEs' reforms (see section 5.3) have not introduced more room for market forces. Indeed, rather than enhancing competition in the respective sectors where SOEs are present, as well as by relinquishing at least the direct operational control of the Government and Party over SOEs, the opposite was done. These recent developments suggest that the goal of allowing markets to play a '*decisive role in resource allocation'*, as proclaimed by the 3rd Plenum decision, definitely gave way to other objectives pursued by the Government and the CCP, in particular consolidation and expansion.

The SOE reforms will morph and feed into a variety of Government industrial policies, such as the 13the FYP (see section 4.2.7), sectoral industrial plans (see e.g. Chapters 14, 15 and 16), Made in China 2025 (see Chapter 4.2.3), the SSSR (see Chapter 4.2.5) etc. [366]

The current Government objectives concerning SOEs are aptly summarized in the 13th FYP which, in an apparent contrast to the 3rd Plenum Decision back in 2013, no longer directs them to '*adapt to the new market-oriented* […] *background*' and '*promote market-oriented allocation of public resources*'.[367] While the relevant chapter in Part 3 of the 13th FYP is entitled '*Vigorously promote the reform of state-owned enterprises*',[368] the primary goal of the 13th FYP with respect to SOEs is unequivocally one of making the State sector bigger and stronger: '*Continue to make state owned enterprises stronger and better, foster a group of key enterprises which have self-innovation capacity and international competitiveness, strengthen the vitality of the state-owned economy, its control, influence and risk resistance capacity, in order to better serve the strategic goals of the country.*'[369] The reforms appear to focus mostly on advocating better control over state-owned assets: '*Give priority to the management of capital and strengthen the supervision of state-owned assets, increase capital returns and prevent the loss of state-owned assets.*'[370] Moreover, the 13th FYP does not distinguish between SOEs in strategic and SOEs in competitive sectors.

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[364] See Michael, M. (2017). Exclusive: In China, the Party's push for influence inside foreign firms stirs fears. *Reuters*; https://www.reuters.com/article/us-china-congress-companies-idUSKCN1B40JU (accessed on 25 August 2017).
[365] See Hughes, J. (2017). China's Communist party writes itself into Company Law. *Financial Times*; https://www.ft.com/content/a4b28218-80db-11e7-94e2-c5b903247afd, (accessed on 18 August 2017).
[366] See further Naughton, B. (2016). *State Enterprise Reform: Missing In Action*. China Economic Quarterly June 2016. Gavekal Dragonomics, p. 20-21
[367] See the 3rd Plenum Decision', Section 2 (7).
[368] See Sub-chapter (1) of the 13th FYP, Part 3, Chapter 11.
[369] Ibid.
[370] Ibid.

This explicit preference for stronger and bigger SOEs is mirrored in sectoral and provincial 13th FYPs. For instance the Steel Industry Adjustment and Upgrade Plan (see Chapter 14) calls for '*set[ting] up several world-class specific backbone enterprises in the field of stainless steel, special steel, seamless steel tubes etc., so as to avoid a competitive vicious circle as regards high-end products of the same quality.*'[371]

In the same vein, the recent Guiding Opinions of the General Office of the State Council on Promoting the Restructuring and Reorganization of Central Enterprises ('2016 Guiding Opinions'), issued in July 2016,[372] emphasize the importance of the general requirement to '*uphold the dominant position of public ownership, play the leading role of the State-owned economic sector*'.[373] They also list a number of guiding principles, the first one of which is the principle of serving national strategies. Hence, '*during the restructuring and reorganization of central enterprises, it is imperative to serve national development goals, implement national development strategies, enforce national industrial policies, strengthen the regulation of State-owned assets by focusing on capital management, and constantly promote the optimal allocation of State-owned capital.*'[374] Based on these requirements and principles, the 2016 Guiding Opinions lay down the main objective, according to which by 2020, SOEs should have '*a more accurate strategic position, more logical general structure, and significantly improved efficiency in capital allocation. A group of innovative and competitive SOEs can play a leading position in the world.*'[375]

This wider context of the most recent FYPs and the practical steps taken by the Government clearly demonstrate that certain ambiguities that may have been present in older documents (i.e. the alleged conflict between market principles and the role of the State) have now been removed:

- First, rather than diminishing the State presence in SOEs by means of privatization, the recent developments show that the Government and the CCP opted for further consolidation of SOEs (see section 5.5.1) by striving to create national and even international champions which would exert considerable market power and would thereby be in position to withstand competition from more efficient market players.[376]
- Second, rather than focusing on the overall economic performance of SOEs, the Government decided to maintain SOEs as means for pursuing numerous policy

[371] See Part IV - Main Tasks, Chapter 7 - Foster mergers and restructuring of the Steel Industry Adjustment and Upgrade Plan (2016 – 2020)
[372] Guiding Opinions of the General Office of the State Council on Promoting the Restructuring and Reorganization of Central Enterprises, Guo Ban Fa [2016] No.56, promulgated on 17 July 2016. See further *State Council issues guideline on reorganization of SOEs* (2016); http://english.gov.cn/policies/latest_releases/2016/07/26/content_281475402145108.htm (accessed on 10 October 2017), as well as OECD, (2017). *OECD Economic Surveys: China 2017*, OECD Publishing, Paris, p. 34
[373] See 2016 Guiding Opinions, point 1(1).
[374] Ibid., point 1(2).
[375] Ibid., point 2.
[376] See also Komesaroff, M. (2016). Return of the Line Ministries. *China Economic Quarterly*, Vol. 20 No. 2. Gavekal Dragonomics.

objectives (controlling strategic sectors, meeting growth targets, social stabilization by providing employment etc.) not based primarily on commercial considerations.[377]

5.6. CHAPTER SUMMARY

In China, SOEs represent an important and comparatively large portion of the national economy (see section 5.1). They will continue to do so for the foreseeable future. According to the relevant laws and policy documents, the State sector is explicitly considered as a pillar of the socialist market economy. The IMF estimates Chinese SOEs account for 40% of total industrial assets and for about half of the bank credits. Figures about the SOEs share in the total Chinese output vary and go up to 30% (see section 5.1). These figures are likely to be understated because they do not include joint ventures that SOEs hold together with private companies. SOEs are increasing their presence in the service economy and strong SOE presence can be also observed in utilities, the finance sector, telecommunication, transport industry and a broad range of manufacturing industries including steel and chemicals.

The existing legal framework is based on the principles of the socialist market economy in which the development and the consolidation of the State economy feature among the central principles. The particular role of SOEs (*'the leading force in the national economy*') is anchored in the Constitution and the relevant constitutional principles are reiterated and elaborated in secondary legislation. It falls upon the State to assume that task to consolidate and ensure the growth of the state-owned economy (see section 5.3). Consequently, the applicable laws confer upon the Government significant powers which allow it to effectively control SOEs, be it via dedicated supervision bodies – SASAC and local SASACs, be it by directly participating in the operational decision-making of SOEs (see section 5.5.2). In addition, the relevant legal framework also provides for an important role of the CCP (see section 5.3).

Against this background, the Government and Party have not shied away from exercising the powers available. In particular, the authorities have engaged in shaping the structure of the state-owned sector by a policy of consolidation through mergers (see section 5.5.1) which can pursue various motives, such as to avoid the closure of facilities contributing to excess capacity by putting ailing companies under the wings of a stronger partner or to create national and even international champions. Chinese authorities have continued controlling the behaviour of SOEs by means of nominating and dismissing its management (see section 5.5.2). While the motivations of specific instances of supervision and guidance over SOEs may vary, the recent developments in China show a clear tendency to put off market oriented reforms which may have been present in the State authorities' considerations still around 2013 (see section 5.3). The government policies which emerged in the wake of the 3rd Plenum Decision (see section 5.3) clearly showed the government's determination to further develop

[377] Which in turn has further negative impacts on the economic performace of SEOs. See Batson, A. (2017). *The State of the State Sector*. Gavekal Dragonomics, p. 9.

the dominant role of the state-owned economy, in particular by selectively creating large SOEs, shielded from competition domestically and expanding internationally which would serve the Government's strategic industrial policies rather than focusing on their own economic performance (see section 5.5.4). In other words, the management of SOEs does not appear to be conducted on an arm's length basis, contrary to normal practice in modern market-based economies.

Such overall institutional setup and legal environment are conducive to business practices which have been amply documented with relation to Chinese SOEs, such as preferential access to finances (see Chapter 6), protection by market access restrictions (see Chapter 8), preferential access to land (see Chapter 9), energy (see Chapter 10) etc. and which result is distorting the effective allocation of resources.

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6.1. INTRODUCTION

The Chinese financial sector plays a fundamental role in the country's economic performance. Throughout nearly three decades of reform, China's financial system has undergone a deep transformation moving from a '*monobank*' system to a '*multi-layered*' system with specialized roles.[378] Nevertheless, the current Chinese financial system is still characterized by a strong State presence, as well as by strong institutional and regulatory controls, which will be further described in this chapter. The Chinese state uses its strong presence in the financial sector in order to implement a wide array of policies.

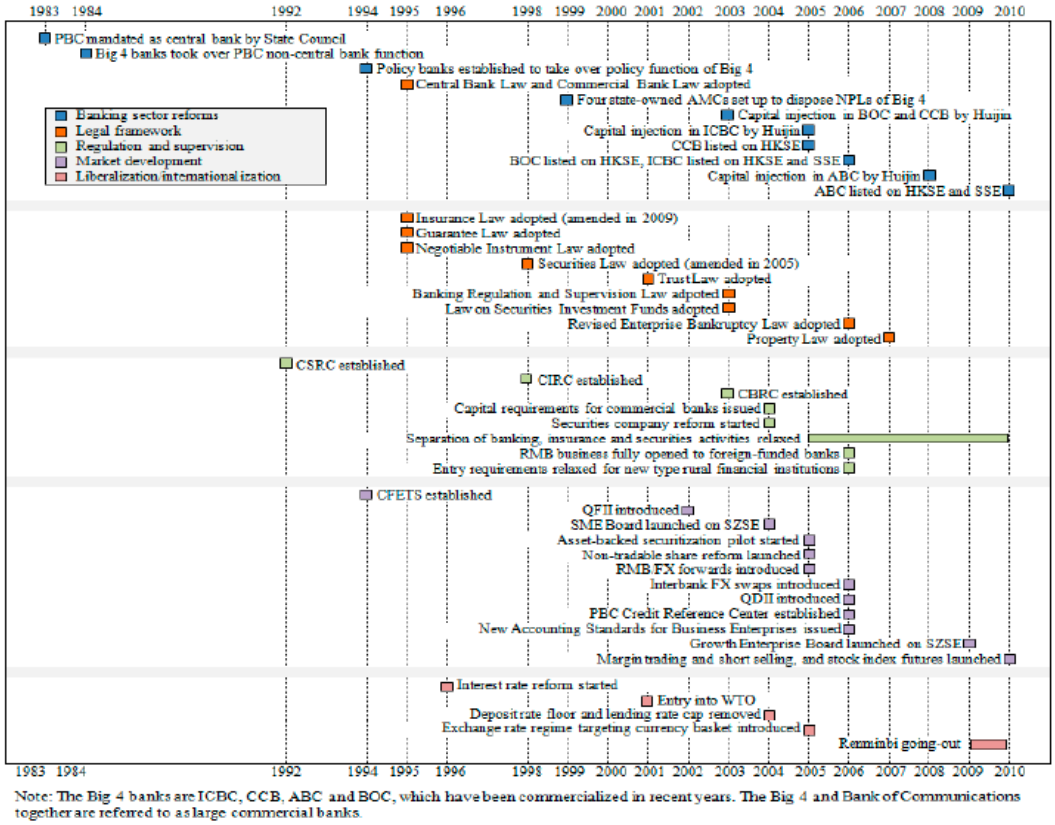
6.2. OVERVIEW OF THE CHINESE FINANCIAL SYSTEM

6.2.1. HISTORICAL BACKGROUND

Before 1984, the People's Bank of China ('PBOC') – a department of the Chinese government under the State Council – served as the primary financial intermediary in China, and the private banking sector virtually did not exist. Since then, China has made progress in moving toward a more commercially-oriented financial system. This has been underpinned by reforms that included recapitalizing the banking system, creating new capital markets, introducing a prudential regulatory regime, opening the financial system following accession to the World Trade Organization, reforming the joint-stock banks and the rural credit cooperatives and taking steps to reform interest rate and the exchange rate policies. In the securities sector, key companies have been restructured, and a resolution mechanism and investor protection scheme set up. Pension sector reform has also progressed, with a National Social Security Fund established in 2000.[379]

[378] IMF. (2006). *Progress in China's Banking Sector Reform: Has Bank Behaviour Changed?* IMF Working Paper WP/06/71 2006, p.3.
[379] IMF. (2011). *People's Republic of China: Financial System Stability Assessment*, Country Report No. 11/321, p.19.

Figure 5: An overview of financial sector reforms from the 1980's until 2010



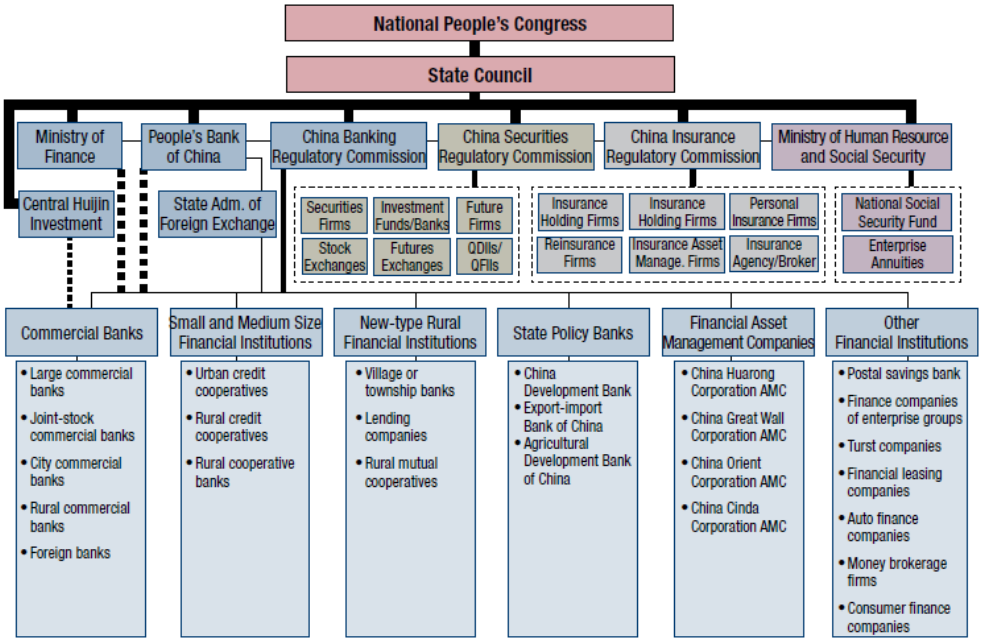
Note: The Big 4 banks are ICBC, CCB, ABC and BOC, which have been commercialized in recent years. The Big 4 and Bank of Communications together are referred to as large commercial banks.

Source: IMF. (2011). *People's Republic of China: Financial System Stability Assessment*, Country Report No. 11/321, p.20.

6.2.2. CURRENT CHINESE FINANCIAL SYSTEM

Currently, the financial sector is structured as follows:

Figure 6 Structure of the financial sector in China



Source: IMF. (2011). *People's Republic of China: Financial System Stability Assessment*, Country Report No. 11/321, p. 40.

Notes from the IMF Report*: 'The thickest connecting lines correspond to the highest levels of authority in financial policy making. The dotted connecting lines indicate the three primary functions of PBC—formulating monetary policy, maintaining financial stability, and providing financial services—and the triple role of the Ministry of Finance ('MOF') as tax administrator, treasurer, and owner of several commercial banks. The thinner connecting lines emerging from China Banking Regulatory Commission ('CBRC'), China Securities Regulatory Commission ('CSRC'), China Insurance Regulatory Commission ('CIRC'), and Ministry of Human Resource and Social Security ('MHRSS') reflect that these entities are mostly responsible for regulating and conducting supervision and oversight of their respective financial sectors'.*[380]

As can be seen from the graph above, the influence displayed by the Government in the financial sector is channelled through a complex set of actors:[381]

- The NPC promulgates all financial sector laws.
- The State Council executes financial regulation and issues mandatory policy directives to all the financial regulatory and supervisory agencies.
- The PBOC's primary role is to carry out the monetary policy of the country and to control financial stability and systemic risks. However, it has as well a secondary yet important regulatory role in the field.[382]
- Central Huijin Investment exercises rights and obligations as an investor in major state-owned financial enterprises on behalf of the State. MOF owns directly and indirectly, through Central Huijin Investment, significant participations in the most important commercial banks of China. It is therefore the biggest shareholder of the Chinese banking system (see also section 6.3 below).
- The CBRC is the primary institution in charge of banking regulation.[383] Thus, it formulates the most important rules and regulations governing the banking institutions.
- The CSRC and CIRC are the primary institutions in charge of regulation in the field of securities and insurance.[384]
- The State Administration of Foreign Exchange ('SAFE') is responsible for the supervision and management of the foreign exchange market.
- The National Council for Social Security Fund has a dual role as an institutional investor and a stakeholder in some of the largest commercial banks.

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[380] Ibid., p. 40
[381] Ibid., p.19.
[382] The main functions of the PBOC can be consulted on its English website, http://www.pbc.gov.cn/english/130712/index.html (accessed on 29 August 2017).
[383] The main functions of the CBRC can be consulted on its English website, http://www.cbrc.gov.cn/showyjhjjindex.do (accessed on 29 August 2017).
[384] The main functions of the CSRC and the CIRC can be consulted on their English website: http://www.csrc.gov.cn/pub/csrc_en/about/ & http://www.circ.gov.cn/web/site45/tab2744/info24831.htm (accessed on 29 August 2017).

- In addition to the players represented in the figure above, the State Council has also established a Financial Stability and Development Commission mid-2017. Its main duties are to implement the decisions made by the Central Party Committee and the State Council in the financial sector; to review major plans for the reform and development of the financial sector; to make overall plans for the development and regulation of financial reform; to coordinate matters related to monetary policy and financial regulation; to coordinate major financial regulatory issues and related fiscal and industrial policies; to analyze and judge the international and domestic financial situations, to cope with international financial risks, to study systematic financial risk prevention and to maintain major financial stability policies.[385]

6.3. THE CHINESE BANKING SECTOR

China's financial system is dominated by the banking sector, providing the private sector with credit amounting to 128% of GDP in 2012, compared to only 41% of GDP for the bond market and 44% of GDP for the stock market.[386] The importance of the banking sector in the allocation of financial resources is also reflected in the 2016 annual report of the PBOC, which shows that RMB-denominated bank loans represented 67.4% of total social financing in China,[387] compared to only 11.5% for corporate bonds, and 3.7% for domestic equity financing.[388] The remaining 17.4% are trust loans, banker's acceptances, designated loans, foreign currency loans, etc. Note that total social financing is a concept that only exists in China, and it includes banks, bonds, equity, but also some transactions from the '*shadow banking*' sector, such as trust loans.[389]

This banking sector is characterized by three predominant categories of state-owned and controlled banks, namely large commercial banks, joint-stock commercial banks, and State policy banks.[390] Together these banks represented almost 70% of the total banking assets in China in 2015, as illustrated in table 5 below:

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[385] See Chinese government website, 国务院金融稳定发展委员会成立并召开第一次会议, Available at: http://www.gov.cn/xinwen/2017-11/08/content_5238161.htm (accessed on 22 November 2017)
[386] Elliott, D.J. and Yan, K. (2013). *The Chinese Financial System, An Introduction and Overview*, John L. Thornton China Center at Brookings, Monograph Series, Number 6, July 2013, p.8
[387] 'Total social financing' is an indicator developed by the PBOC to measure the total funding of the 'real' economy (defined as non-financial enterprises and households) by the financial system.
[388] PBOC. (2016). *Annual Report*, p.87. Available at: http://upload.xh08.cn/2017/0705/1499248732384.pdf (accessed on 22 November 2017)
[389] For more information on shadow banking components, see also Elliott, D., Kroeber, A. and Qiao, Y. (2015). *Shadow banking in China: A primer*, Economic Studies at Brookings, The Brookings Institution, p.7.
[390] See http://www.cbrc.gov.cn/chinese/jrjg/index.html. MOF or Central Huijin are the largest shareholders of policy banks and large commercial banks, while SOEs or local governments are the largest shareholders of joint-stock commercial banks.

Table 5: Total Assets of Banking institutions in China

Total assets of banking institutions	2007	2008	2009	2010	2011	2012	2013	2014	2015
Share of total (%)									
Banking institutions total	100%	100%	100%	100%	100%	100%	100%	100%	100%
Policy Banks and CDB	8%	9%	9%	8%	8%	8%	8%	9%	10%
Large commercial banks	54%	52%	51%	49%	47%	45%	43%	41%	39%
Joint stock commercial banks	14%	14%	15%	16%	16%	18%	18%	18%	19%
City commercial banks	6%	7%	7%	8%	9%	9%	10%	10%	11%
Rural commercial banks	1%	1%	2%	3%	4%	5%	6%	7%	8%
Rural cooperative banks	1%	2%	2%	2%	1%	1%	1%	1%	0%
Urban credit cooperatives	0%	0%	0%	0%	0%	0%	0%	0%	0%
Rural credit cooperatives	8%	8%	7%	7%	6%	6%	6%	5%	4%
Non-bank financial institutions	2%	2%	2%	2%	2%	2%	3%	3%	3%
Foreign banks	2%	2%	2%	2%	2%	2%	2%	2%	1%
New type rural financial institions	3%	4%	3%	4%	4%	4%	4%	4%	4%
and Postal savings bank									

Source: CBRC. (2015). *Annual Report*, p.192.

Smaller city and rural commercial banks, which are often owned by local and provincial governments account for most of the remainder.

Foreign-invested banks have continuously played a negligible role in China's banking sector. This is partly due to limitations regarding ownership by foreign investors (see Chapter 8), whereby the maximum share of foreign investment in a domestic financial institution cannot exceed 25%, with no more than 20% owned by a single foreign investor. In addition, informal obstacles, such as the high number of state-owned potential customers, and the corresponding links between local banks and local customers are preventing foreign players to gain market share.[391]

6.3.1. STATE PARTICIPATION IN THE TOP-20 BANKS

6.3.1.1. LARGE COMMERCIAL BANKS

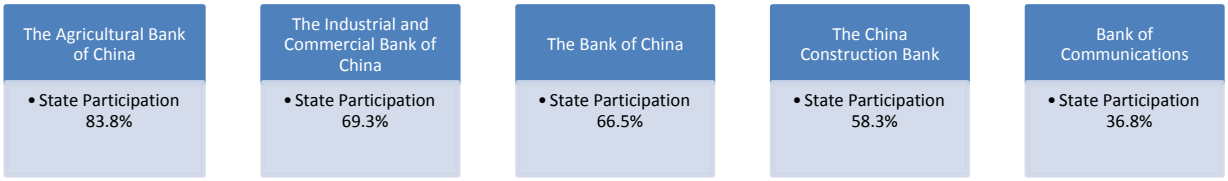
Large commercial banks were introduced in China in the 80's, when four state-owned commercial banks were created in order for the PBOC to concentrate on the classical tasks of a central bank, instead of functioning as a commercial actor. In 1979, the Agricultural Bank of China (ABC) was created to handle government financing of grain procurement and rural development. In the same year, the Bank of China (BOC) took over the foreign currency portfolio. In 1984, the Industrial and Commercial Bank of China (ICBC) started to finance China's SOEs. At the same time, the China Construction Bank (CCB), which had been part of MOF, gained operational independence in order to provide loans to long-term state investment projects. Thus the so-called 'Big Four' state banks were born.[392]

[391] Elliott, D.J. and Yan, K. (2013). *The Chinese Financial System, An Introduction and Overview*, John L. Thornton China Center at Brookings, Monograph Series, Number 6, July 2013, p.29.
[392] Shih, V.C. (2008). *Factions and Finance in China: Elite Conflict and Inflation*, Cambridge University Press, p.31.

As of 2015, the Big Four still constituted the biggest players in the country's banking sector. Together with the Bank of Communications, the five large commercial banks represented almost 40% of the total Chinese financial market in 2015.[393]

The Chinese government is the controlling shareholder in each of these banks, as illustrated below:

Figure 7: State participation in the five largest commercial banks



Source: Annual report 2015 of each bank.

6.3.1.2. JOINT-STOCK COMMERCIAL BANKS

Joint-stock commercial banks are the second most important type of credit institution of the country with a proportion varying over the years of 14-19% of the total banking assets.[394] They constitute a hybrid version between what it is considered to be a general partnership, and a publicly tradable company. As is the case for the large commercial banks, there is also a significant state participation in these banks, either through direct investment by Central Huijin Investment Ltd. or indirectly through other state-owned legal entities.

The following table is mainly based on publicly available annual reports, and provides an overview of the State presence in the joint-stock commercial banks as of 2015:

Table 6: State participation in the joint-stock commercial banks

Name	Approx. percentage of shares owned by the State and state-owned corporations
China Everbright Bank	82.8%
CITIC Industrial Bank	71.55%
China Guangfa Bank	64.96%
Bohai Bank	62.0%
Industrial Bank	43.02%

[393] CBRC. (2016). Annual Report, p. 184.
[394] Ibid.

Shanghai Pudong Development Bank	40.7%
China Merchants Bank	40.45%
Huaxia Bank	39.30%
China Zheshang Bank	28.53%
Evergrowing Bank	19.40%
Ping An Bank	11.4%
China Minsheng Bank	2.66%

Source: Annual report 2015 of each bank.

6.3.1.3. STATE POLICY BANKS

Finally, State Policy banks are the third biggest player of the market with a proportion of 10% of the total banking assets.[395] The three State Policy banks, namely the State Development Bank, the Agricultural Development Bank and the Export-Import Bank (EXIM) were established in 1994 to take over the policy portfolios of the Big Four banks. They are wholly state-owned and explicitly serve the purpose of financing state projects and sustaining economic development in key sectors and areas.

6.3.2. BOARD COMPOSITION AND GOVERNMENTAL TIES

The control of the government over the 20 largest banks does not only entail a mere holding of shares. According to the Articles of Association of the Big Four, as the main shareholder, the Chinese government has the power to appoint the most important positions within the management of the bank, such as the members of the Board of Directors and/or the Board of Supervisors. These Boards are usually responsible for taking decisions on the business strategy and the budget of the bank, taking investment decisions, deciding on senior management appointment or dismissals, and formulating the risk management system of the bank.[396]

Furthermore, the Board of Supervisors of the key state-owned financial institutions is appointed according to the Interim Regulations of Board of Supervisors of State-owned Key Financial Institutions. According to Articles 3 and 5 of these Interim Regulations, the

[395] Ibid., p. 192.
[396] For a more detailed overview per bank, please refer to Commission Implementing Regulation (EU) 2017/969 of 8 June 2017 imposing definitive countervailing duties on imports of certain hot-rolled flat products of iron, non-alloy or other alloy steel originating in the People's Republic of China and amending Commission Implementing Regulation (EU) 2017/649 imposing a definitive anti-dumping duty on imports of certain hot-rolled flat products of iron, non-alloy or other alloy steel originating in the People's Republic of China (OJ L146, 09.06.2017, p.17), recitals 92 to 99.

Members of the Board of Supervisors of such financial institutions are dispatched by and accountable to the State Council.[397]

Key state-owned financial institutions are defined in Article 2 of the above-mentioned Regulation, but the definition remains somewhat unclear. Article 2 stipulates:

> *The key State-owned financial institutions mentioned in these Regulations refer to State-owned policy banks, commercial banks, financial assets management companies, securities companies, insurance companies, etc. (hereinafter referred to as State-owned financial institutions), to which the State Council dispatches boards of supervisors. The list of State-owned financial institutions to which the State Council dispatches boards of supervisors shall be recommended by the administrative organ for boards of supervisors in State-owned financial institutions (hereinafter referred to as the administrative organ for boards of supervisors) and submitted to the State Council for determination.*

In addition, in 2017, the role of Party organisations in the business activities of state-owned banks has been strengthened. As already mentioned in chapter 2 above, the State Council has approved an action plan to reform SOEs,[398] and more than 30 Hong Kong-listed state-owned enterprises, representing more than USD 1 trillion, have adjusted their articles of association to grant the Party a more visible role.[399]

One of these enterprises is the ICBC, which has now a specific chapter on the creation of a Party committee.[400] According to this chapter, '*the chairman of the board of directors of the Bank and the secretary of the Party Committee shall be the same person*'.[401] Article 53 then lists the duties of the Party committee, among which the monitoring of the practical implementation of Party and State decisions in the bank. The Party committee is also playing a role in the selection and evaluation of personnel, together with the board of directors. Finally, the Party committee is to be involved in the discussion of '*major operational and management issues and major issues concerning employee interests, and put forth comments and suggestions*'.[402]

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[397] Commission Implementing Regulation (EU) 2017/969 of 8 June 2017, recital 90
[398] Action plan to reform central SOEs toward corporations, 26 July 2017, http://english.gov.cn/policies/latest_releases/2017/05/03/content_281475644421269.htm (accessed on 12 October 2017)
[399] Hughes, J. (2017). *China's Communist party writes itself into Company Law,* Financial Times, 14 August 2017, https://www.ft.com/content/a4b28218-80db-11e7-94e2-c5b903247afd (accessed on 10 October 2017)
[400] Articles of Association of ICBC, chapter 6, articles 52-53, http://v.icbc.com.cn/userfiles/Resources/ICBCLTD/download/2017/gszc_en.pdf (accessed on 17 November 2017)
[401] Ibid, Article 52
[402] Ibid, Article 53 (3)

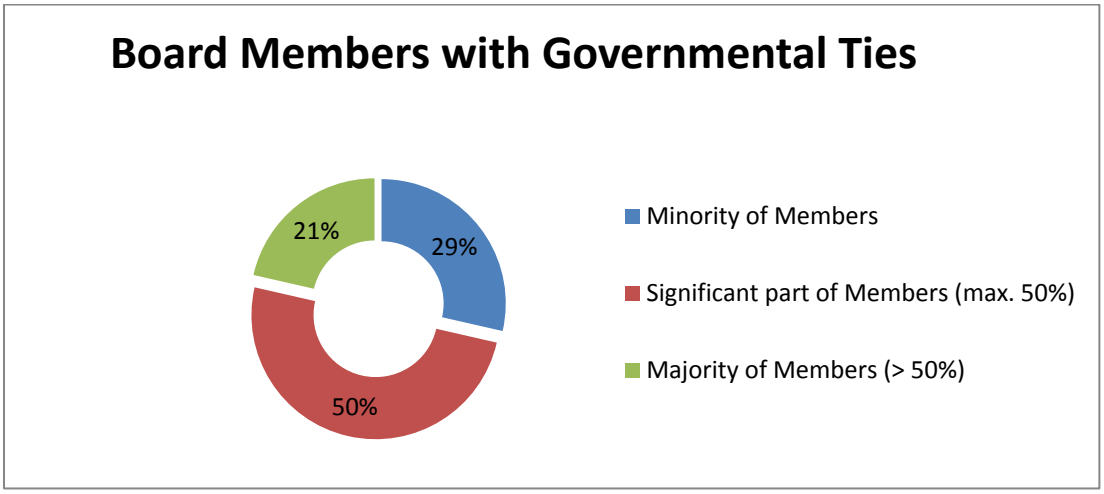
Changes have also been made to the provisions concerning the board of directors, stating that the Party committee has to be consulted before material issues are decided upon.[403]

Generally speaking, the top executives of all large state-owned financial institutions are appointed by the Organization Department of the CCP[404] (see Chapter 3.3) and approved by the CBRC,[405] meaning that various party bodies and important party members can exert a certain influence over personnel and business decisions in the financial institutions. According to a study from 2010, all of the leaders of the 20 major financial institutions were appointed by the government. [406]

Moreover, the highest executives of these financial institutions all have political ranks similar to local and central government officials. For example, the political rank of the CEO of the BOC is the same level as that of the vice president of the PBOC or a vice governor of a province.[407]

Finally, an analysis of the individual profile of the 2015 members of the board of directors of the banks mentioned in section 3.1 above revealed that most of the board of director's seats were assigned to professionals who are connected to the governmental apparatus.[408] They had either worked for governmental institutions, had political roles in cities or regions of the PRC (i.e. mayor), or are members of the CCP.

Figure 8: Board Members with Governmental Ties



Source: Compiled by the Commission on the basis of the 2015 annual reports of the 20 largest banks

[403] Ibid, Article 144
[404] Shih V.C. (2008). *Factions and Finance in China: Elite Conflict and Inflation*, Cambridge University Press, pp.39, 43-44
[405] Ibid., p.39
[406] Lin, N. (2010). *Capitalism in China: A Centrally Managed Capitalism (CMC) and Its Future*, in Management and Organization Review, Volume 7, Editor's Forum: Chinese Capitalism, pp. 63-96, p.77.
[407] Elliott, D.J. and Yan, K. (2013). *The Chinese Financial System, An Introduction and Overview*, John L. Thornton China Center at Brookings, Monograph Series, Number 6, July 2013, p.11.
[408] The analysis has been restricted to the 20 major Chinese Banks mentioned in section 3.1.

More specifically, in 21% of the cases, more than half of the members of the board of directors were connected to the government. In 50% of the cases, half or less than half of the board's seats were taken by professionals connected to the government. This illustrates again the institutional control of the State on the state-owned banks' activities.

6.3.3. OVERALL LEGAL FRAMEWORK

In addition to the overall institutional influence of the State over the banks described above, Chinese financial institutions are also operating in a general legal environment that directs them to align themselves with the country's industrial policy objectives when taking financial decisions. In this section, only a brief overview of the main legal documents is provided (for more details see Chapter 2.1).

6.3.3.1. BANKING LAW

The Law of the People's Republic of China on Commercial Banks (Banking Law),[409] in Article 1 regulates the behaviour and interests of the banks, the interests of depositors and clients, the quality of the banks' assets, their supervision, and it also promotes the development of the socialist market economy.[410]

Article 34 states that: '*Commercial banks shall conduct their business of lending in accordance with the needs of the national economic and social development and under the guidance of the industrial policies of the State*.'[411] Thus, the Banking Law directs banks to promote a lending strategy which supports the industrial policies of the state.

The room for manoeuvre of the banks is further constrained by Article 38, which determines that the range of interest rates which a commercial bank may charge in the course of its business can only fluctuate between the lower and upper limits set by the PBOC.[412] In the past, the PBOC indeed set minimum and maximum interest rates for loans and deposits via executive regulatory acts. Since October 2015, the PBOC has removed these limits. However, Article 38 of the Banking Law, which is the legal basis for the PBOC's regulatory acts, has not been adapted accordingly, so that such limits may again be imposed at any time by the PBOC. In addition, the PBOC still publishes benchmark interest rates, which are used by the financial institutions as a basis for determining individual lending rates.

The provisions of Articles 34 and 38 are somewhat softened by Article 7 concerning the examination of the creditworthiness of the borrower, and Article 4 relating to the bank's autonomy, and the fact that 'c*ommercial banks shall, pursuant to law, conduct business operations without interference from any unit or individual'.*[413] However, this formulation

[409] Law of the People's Republic of China on Commercial Banks, Order No. 34 of the President of the People's Republic of China, promulgated on 29/08/2015.
[410] Banking Law, Article 1.
[411] Ibid., Article 34.
[412] Ibid., Article 38.
[413] Ibid., Article 4.

does not shield banks from their duty to apply public policy considerations as set out in Article 34 of the Banking Law. In other words, Articles 4 and 7 of the Banking Law can very well be applied subject to Article 34.

6.3.3.2. THE GENERAL RULES ON LOANS

The main purpose of The General Rules on Loans, [414] promulgated by the PBOC in 1996, is to regulate the activities connected with loans, to protect the legitimate rights and interests of both parties to borrowing and lending, to ensure the safety of credit and loan assets, to improve the overall results from loan utilization, and to promote steady socio-economic development.[415]

Article 7 of The General Rules on Loans states that: '*Special-purpose loan means a loan which is made by a fully-State-owned commercial bank with approval and authorization of the State Council and with necessary remedies having been taken in advance for any possible loan loss*.'[416] Special loans referred to in Article 7 of the General Rules on Loans mentioned above were eliminated in 1999 based on a Circular on Improving the Administration of Special Loans,[417] but the Circular was then annulled in 2007[418] and Article 7 remains in effect.

Additionally, Article 15 establishes that interest on loans may be subsidized when in accordance with the state's policy to promote the growth of certain industries and economic areas.[419]

6.3.3.3. DECISION NO 40

Article 17 of Decision No 40[420] (see chapter 4) provides that investment projects in the '*Encouraged*' category shall benefit from specific privileges and incentives, inter alia, from financial support. By contrast, Articles 18 and 19 provide that the relevant authorities can prevent financial institutions from supplying loans to '*Restricted*' and '*Prohibited*' projects. Hence, Decision No 40 provides binding rules to all the economic institutions in the form of directives on the promotion and support of encouraged industries.[421]

Decision No 40 shows how the government supports groups of enterprises or industries through the provision of credit support by financial institutions to encouraged industries. It echoes in part Article 34 of the Banking Law, namely that financial institutions should take

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[414] The General Rules on Loans promulgated by the PBOC on 28 June 1996
[415] Chapter 1, Article 1 of The General Rules on Loans promulgated by the PBOC on 28 June 1996.
[416] Ibid., Chapter 2, Article 7.
[417] Circular on Improving the Administration of Special Loans, YINFA [1999] No. 228
[418] See http://www.fdi.gov.cn/1800000121_39_3581_0_7.html (accessed on 29 August 2017).
[419] *Ibid.*, Chapter 3, Article 15.
[420] Decision of the State Council Regarding Promulgating the Implementation of Interim Provisions on the Promotion of Industrial Restructuring, 2 December 2005, Guo Fa [2005] No.40
[421] Commission Implementing Regulation (EU) No 215/2013 of 16 December 2014, para. 182.

into account industrial state policies when providing loans. Chapter 11 will furthermore show that this support is actually provided on preferential terms.

In short, the legal framework which has been described above is shaped to serve policy purposes. The government identifies economic priorities and projects of national interests, and funds are then channelled as a priority to these projects via the banks whenever deemed necessary.

6.3.3.4. LAW OF THE PEOPLE'S REPUBLIC OF CHINA ON SECURITIES

The Law of the People's Republic of China on Securities, [422] originally effective as of January 2006 and most recently amended in August 2014, regulates the issuance and trading of securities on Chinese exchange markets.

According to Article 16 of the Securities Law, the public issuance of corporate bonds should satisfy the following requirements:

> *(4) the investment of raised funds shall comply with the industrial policies of the State […],*
>
> *The funds as raised […] shall be used for the purpose as verified […]*

Furthermore, Article 51 states in relation to listings on the Chinese stock exchange that *'The State encourages the listing of corporate stocks that comply with the relevant industrial policies and fulfil the general requirements of listing'.*

The legal framework for the bond and the stock market, as established under the Law on Securities, thus follows the same logic as the legislation relating to bank loans. The State presence and interference on these two markets are further developed in the next two sections, tending to show that bonds and shares are also used for channelling capital to priority projects in line with the state's industrial policies.

6.4. THE CHINESE BOND MARKET

6.4.1. STRUCTURE AND STATE PRESENCE ON THE CHINESE BOND MARKET

The Chinese bond market is much smaller than in the US and Europe but is growing rapidly.

As was the case for the banking sector, the Chinese bond market is dominated by government-related players. In total, government and government-related issues account for about three quarters of the Chinese bond market. Furthermore, the non-governmental public bond market is dominated by the SOEs. Yet the market share, in terms of the issue amount, by

[422] The Law of the People's Republic of China on Securities, revised and adopted at the 18th Meeting of the Standing Committee of the Tenth National People's Congress of the People's Republic of China on October 27, 2005, and effective as of January 1, 2006. The current version was promulgated on August 31, 2014.

non-SOEs has increased from 12.6% in 2009 to 25.7% in 2015, as the government has tried to encourage more direct financing, especially by private enterprises.

Non-governmental public bonds include the following four types: enterprise bonds, corporate bonds, medium term notes, and financial bonds. They differ in terms of regulation, issuer industry, and trading venues. The figure below summarizes the differences among these four types of public bonds:

Figure 9: Representative Types of Non-governmental Chinese Bond Issues

This Table lists the four types of non-governmental Chinese public bond issues and summarizes their major differences.

	Regulators*	Issuing Approval	Trading Venues	Issuers	Governing Law/Regulation
Enterprise Bonds	NDRC	Permission from NDRC	Exchange and Interbank Markets	Non-financial institutions. Mostly SOEs and non-listed firms	*Regulations on Administration of Enterprise Bonds* (State Council, 1993) *Regulations on Administration of Enterprise Bonds* (State Council, 2011)
Corporate Bonds	CSRC	Permission from CSRC	Exchange Market	Non-financial institutions. Mostly listed firms.	*Pilot Rules on the Issuance of Corporate Bonds* (CSRC, 2007a) *Measures for the Administration of Corporate Bonds Issuance and Trading* (CSRC, 2015)
Medium Term Notes	PBoC	Registration with PBoC	Interbank Market	Non-financial institutions	*Administrative Measures for Debt Financing Instruments of Non-Financial Enterprises in the Inter-bank Bond Market* (PBoC, 2008)
Financial Bonds	PBoC	Permission from PBoC	Interbank Market	Banks, finance companies, and other financial institutions	*Administrative Measures for the Issuance of Financial Bonds in the National Inter-bank Bond Market* (PBoC, 2005)

Source: Livingston, M. Poon, W.P.H. and Zhou, L. (2017). *Are Chinese Credit Ratings Relevant? A Study of the Chinese Bond Market and Credit Rating Industry*, in Journal of Banking & Finance, p.29.

Issuers need to apply for permission from their respective regulators to issue bonds. Enterprise bonds for example need to be approved by the NDRC, one of the criteria for approval being the consistency with national industrial policy objectives.[423] Corporate bonds are approved by another governmental actor, the CSRC, and only account for 19% of the outstanding balance of Chinese bonds as of June 2016.

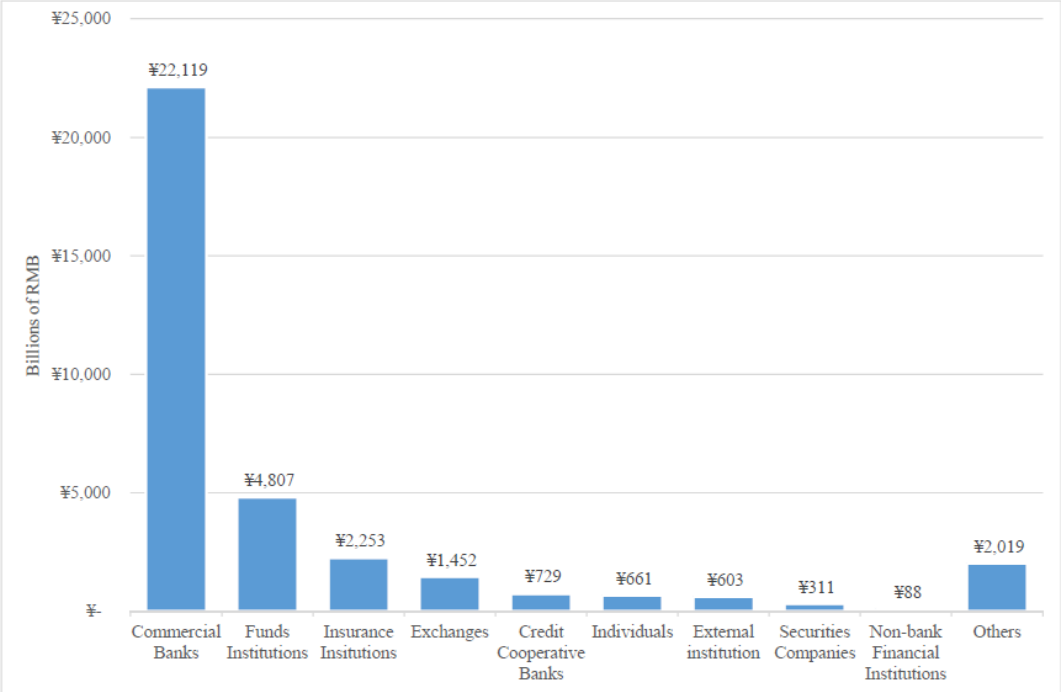
There are no formal restrictions on the use of funds for MTNs, but their issuance is approved by NAFMII, which is a self-regulatory organization under the supervision of the PBOC. Its members include officials from PBOC, NDRC, MOF, and the CIRC. As such, it is '*not substantively distinguishable from other organs of the Party-state.*'[424]

The interbank market on which the bonds are traded is regulated by the PBOC and the NAFMII and serves as a wholesale market for institutional investors, including banks and other institutional investors, such as Qualified Foreign Institutional Investors ('QFII'). The

[423] Price, A.H., Brightbill T.C., DeFrancesco R.E., Claeys, S.J., Teslik, A. and Neelakantan, U. (2017). *China's broken promises: why it is not a market-economy*, Wiley Rein LLP, p. 66.
[424] Lin, L.W. and Milhaupt, C.J. (2016). *Bonded to the State: A Network Perspective on China's Corporate Debt Market*. Columbia Law and Economics Working Paper No.543, p.30.

interbank market accounts for more than 95% of the total trading volume.[425] In fact, at present the banks are by far the largest holders of corporate bonds, followed by fund institutions and insurance companies. Individual investors only account for a very small portion of the bond market, as can be seen in the figure below.[426] Since there is a significant overlap between the creditors providing capital in the form of bonds and those providing capital in the form of loans, bonds are to a certain extent just another means to provide corporate loans.

Figure 10: Holders of corporate bonds in China (2015)



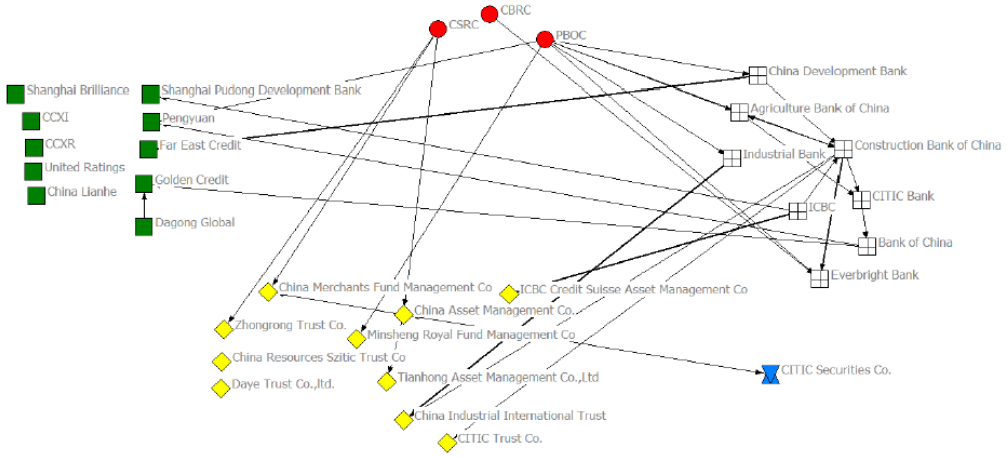
Source: www.chinabond.com.cn, based on data from China Central Depository & Clearing Co., Ltd. (2016). *China's Bond Market Overview 2015*, p.95-96

In addition, within the financial sector, personnel connections are common, particularly the ones flowing from the banks and the PBOC to other financial institutions in the corporate bond network, as demonstrated in the figure below. This figure shows personnel connections among the 52 CEOs/Chairmen of the major players in the corporate bond market.[427] When a chairman or CEO of an organization has previous work experience in another organization, there is a direct link between the two organizations. The graph shows how these organizations are connected with one another through the top managers' career rotations. Of course, extensive personnel connections also exist in the financial industry outside China. But the

[425] Goldman Sachs Asset Management, Global Liquidity Management. (2015). *FAQ: China's Bond Market, first half 2015*. See also http://www.kwm.com/en/knowledge/insights/chinas-onshore-bond-market-open-for-business-20151216#ref-id-here (accessed on 16 November 2016).
[426] China Central Depository & Clearing Co., Ltd. (2016). *China's Bond Market Overview 2015*, p. 95-96.
[427] These players are the credit rating agencies, the ten largest underwriters, the five largest trust companies, the five largest asset management companies, and the largest banks.

Chinese network is largely a closed system: only four of the 52 CEOs/Chairmen reviewed had professional experience outside the State sector.[428]

Figure 11: Personnel connections at top level between organizations in the financial sector



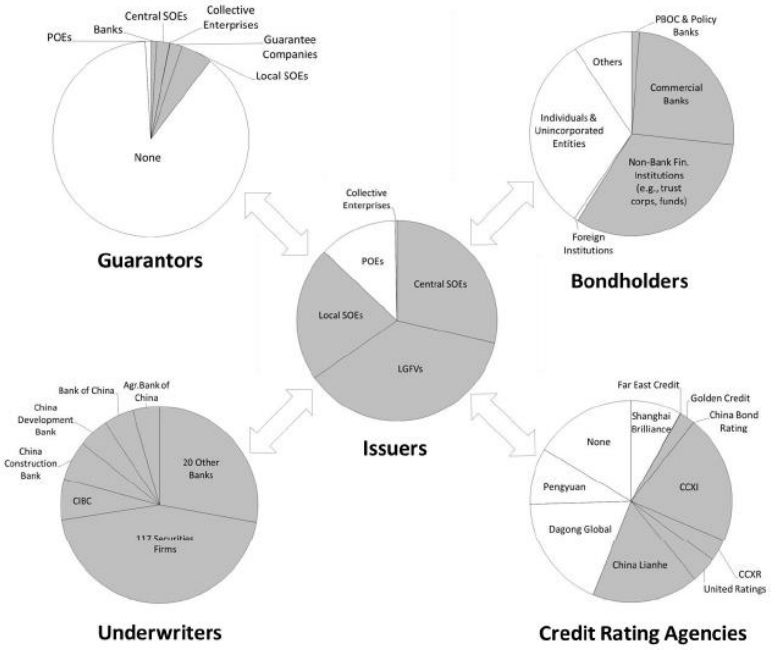
Source: raw data collected from corporate websites and annual reports (as of Dec. 2015).

Source: Li-Wen Lin and Curtis J. Milhaupt, "Bonded to the State: A Network Perspective on China's Corporate Debt Market", Columbia Law and Economics Working Paper No.543 (July 2016), p.28-29
Note: when the chairman or CEO of an organization has previous work experience in another organization, a line will connect the two organizations

In summary, the Chinese bond market is largely dominated by the state, as the access to the market is tightly regulated by governmental institutions, and all the major players on the market (issuers, holders, underwriters of bonds) are mainly state-owned entities. This can be easily seen in the figure below, where the grey shading indicates state ownership.

[428] Graph and explanation taken from Lin, L.W. and Milhaupt, C.J. (2016). *Bonded to the State: A Network Perspective on China's Corporate Debt Market*. Columbia Law and Economics Working Paper No.543, p.28-29.

Figure 12: State ownership on the Chinese bond market



Source: raw data collected from WIND (as of June 30, 2016). Each pie chart represents the total outstanding balance of bonds issued/underwritten/rated/held. Gray shading indicates state ownership; white indicates private ownership.

Source: Lin, L.W. and Milhaupt, C.J. (2016). *Bonded to the State: A Network Perspective on China's Corporate Debt Market*. Columbia Law and Economics Working Paper No.543, p.26

6.4.2. CREDIT RATINGS AND PRICING OF CREDIT RISK ON THE CHINESE BOND MARKET

Not only is China's bond market dominated by the state, as described in section 4.1 above, the credit risk linked to the bonds issued on this market is also determined by state-owned entities.

According to two studies published in 2016, China has close to a dozen domestic credit rating agencies, and in total, 60% of all rated corporate bonds in China had been rated by a state-owned ratings agency.[429] In addition, according to one of these studies, one of the largest domestic credit rating agencies in China, Dagong Global Credit Rating, is 'private' from the standpoint of equity ownership, but has its origins in the government and is led by a politically well-connected controlling shareholder whose business model is closely aligned with the policy objectives of the government.[430] Furthermore, as was shown in the last graph of section 6.4.1, actors on the credit rating market are closely linked to the other state-owned players on the bond market.

[429] Lin, L.W. and Milhaupt, C.J. (2016). *Bonded to the State: A Network Perspective on China's Corporate Debt Market*. Columbia Law and Economics Working Paper No.543, p. 20; Livingstone, M. Poon, W.P.H. and Zhou, L. (2017). *Are Chinese Credit Ratings Relevant? A Study of the Chinese Bond Market and Credit Rating Industry*, in Journal of Banking & Finance. p.9

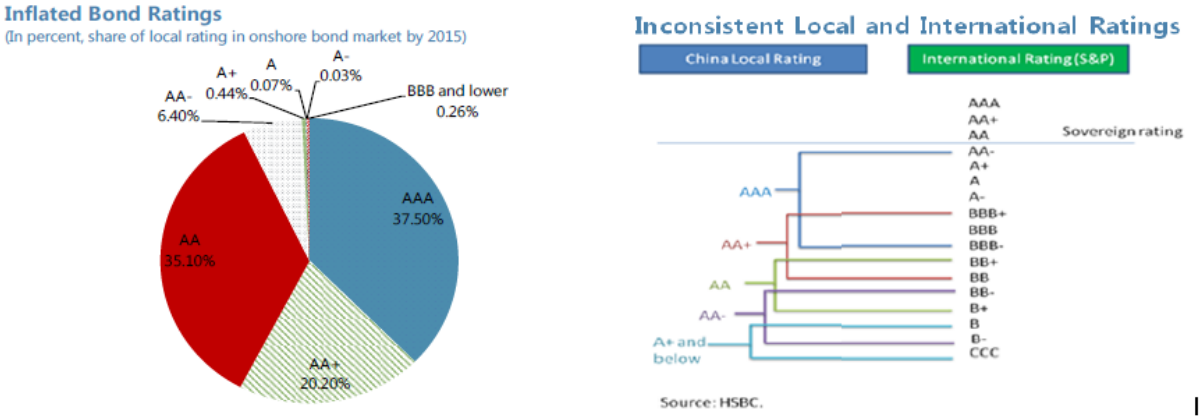
[430] Lin, L.W. and Milhaupt, C.J. (2016). *Bonded to the State: A Network Perspective on China's Corporate Debt Market*. Columbia Law and Economics Working Paper No.543, p. 20.

Foreign rating agencies, such as Standard and Poor's and Moody's are present on the Chinese market, but they do not rate bonds issued on the domestic market themselves.[431] They rather concentrate on Chinese bonds issued overseas. However, in this case, they typically apply an uplift over the issuer's baseline credit rating based on an estimate of the firm's strategic importance to the Chinese government and the strength of any implicit guarantee.[432] Fitch for example clearly indicates, where applicable, that such guarantees are a key driver underlying its credit ratings of Chinese companies.[433]

In general, Chinese credit ratings do not provide a reliable estimation of the credit risk of the underlying asset. This is demonstrated by the fact that Chinese credit ratings are heavily skewed towards the highest end of the rating scale. According to the IMF, over 90% of Chinese bonds are rated AA to AAA by local rating agencies. This is not comparable to other markets, such as the EU or the US. For example, less than 2% of firms enjoy such top-notch ratings in the US market. Chinese credit rating agencies thus have very broad rating scales and tend to pool bonds with significantly different default risks into one broad rating category.[434]

The figure below further illustrates this by providing a comparison between Chinese and international credit ratings:

Figure 13: Comparison between Chinese and international credit ratings



Source: IMF. (2016). *Resolving China's Corporate Debt problem*. IMF Working Paper WP/16/203, p. 15.

[431] Until recently, foreign credit rating agencies were prohibited from issuing domestic bond ratings. However, the PBOC announced mid-2017 that overseas credit rating agencies would be allowed to carry out credit ratings on part of the domestic bond market, under certain conditions. See 'Announcement of PBOC on Issues concerning the Credit Rating Business Carried out by Credit Rating Agencies on the Interbank Bond Market', effective on July 1, 2017.

[432] Price, A.H., Brightbill T.C., DeFrancesco R.E., Claeys, S.J., Teslik, A. and Neelakantan, U. (2017). *China's broken promises: why it is not a market-economy*, Wiley Rein LLP, p.68.

[433] For a concrete example, see Reuters. (2016). *Fitch Rates Shougang's USD Senior Notes Final 'A-'* https://www.reuters.com/article/idUSFit982112, (accessed on 21 October 2017)

[434] Livingston, M. Poon, W.P.H. and Zhou, L. (2017*). Are Chinese Credit Ratings Relevant? A Study of the Chinese Bond Market and Credit Rating Industry*, in Journal of Banking & Finance, p.24.

The right hand table shows an estimation of what a Chinese rating could correspond to in terms of international ratings. For instance AAA would correspond to a range from AA- to BBB-. While not necessarily representing a generally accepted standard view, this estimation illustrates the problems with the Chinese credit rating agencies. As for foreign rating agencies, they have established joint ventures with some local credit rating agencies and turned them into their affiliates, which do provide credit ratings for domestic bond issues.[435] However, these ratings follow Chinese rating scales and are thus not exactly comparable with international ratings, as explained above.

These distortions on the credit rating market can be attributed to several factors. First, the relatively high number of rating agencies allow borrowers to choose whichever rating agency can give them a higher rating. Second, and most importantly, the overall state presence on the Chinese bond market has historically led to a situation where bond defaults did not exist. The market has been largely confined to the largest and most politically connected firms, for which default risk has long been considered to be essentially non-existent.[436] In fact, the first default on bonds only occurred in 2014.[437] Since then, 5 domestic bond defaults have taken place in 2014, 21 in 2015, and more than 30 by June 2016. However, these remain isolated incidents, and the Chinese government is not necessarily giving up its bail-outs, particularly in the case of SOE bonds.[438]

Low default rates create expectations, which in turn influence credit assessment. This assumption has been among others corroborated in a recent study, which found that bonds issued by non-SOEs receive lower ratings (about one-third notch lower on average) than those by the SOEs of the central government. In addition to lower bond ratings, yields on non-SOE bonds were about 57 basis points higher than bonds issued by SOEs of central government, holding rating and other bond features constant. This resulted in an overall funding disadvantage of over 70 basis points for non-SOEs, likely due to investors' perceived government backing of SOE bonds.[439]

6.5. THE CHINESE STOCK MARKET

There are two main stock exchanges in China, the Shanghai Stock Exchange ('SHSE') and Shenzhen Stock Exchange ('SZSE'), which were both established in 1990. Some other

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[435] Elliott, D.J. and Yan, K. (2013). *The Chinese Financial System, An Introduction and Overview*, John L. Thornton China Center at Brookings, Monograph Series, Number 6, July 2013, p. 23. It should be noted that the current version of the Catalogue of Industries for Guiding Foreign Investment, amended on June 28, 2017, removed credit rating companies from the restricted category.
[436] Lin, L.W. and Milhaupt, C.J. (2016). *Bonded to the State: A Network Perspective on China's Corporate Debt Market*. Columbia Law and Economics Working Paper No.543, p.35.
[437] Defaults and bankruptcy procedures will be further discussed in section 9 below.
[438] Livingston, M. Poon, W.P.H. and Zhou, L. (2017). *Are Chinese Credit Ratings Relevant? A Study of the Chinese Bond Market and Credit Rating Industry*, in Journal of Banking & Finance, p. 11
[439] Livingston, M. Poon, W.P.H. and Zhou, L. (2017). *Are Chinese Credit Ratings Relevant? A Study of the Chinese Bond Market and Credit Rating Industry*, in Journal of Banking & Finance, p.3

markets have been established to complement the two main exchanges. For example, an electronically operated market for SMEs was opened in 2001, and a 'third-tier market' was established to deal primarily with de-listing firms and other over-the counter ('OTC') transactions. In 2009, a growth enterprise market ('GEM') was established for companies from hi-tech, electronic and pharmaceutical industries.[440] The scale and importance of these stock markets are not comparable to the banking sector, although they have grown rapidly in recent years. In 2015, there were 2 799 companies listed on the two main exchanges, with a market capitalization of more than USD 4 trillion.[441]

Another major stock exchange is located in Hong Kong. The Hong Kong Stock Exchange ('HKSE') is trading a considerable volume of so-called H-shares, which are shares of Chinese firms, usually state-owned, which have gained permission to sell stock in Hong Kong to attract foreign capital. Other different types of shares exist on the Chinese stock markets. A-shares are issued to and traded by Chinese investors, whereas B-shares can be purchased by foreign investors. The number of B-shares is far below the number of A-shares. In addition, SOEs listed on a Chinese stock exchange also have so-called government or G-shares.

In fact, many companies on the stock exchange are SOEs. As of May 2017, five out of the top ten firms listed on the SHSE, accounting for around one quarter of total market capitalization, are SOEs.[442] The capital structure of these SOEs includes tradable and non-tradable shares. In 2005, a plan to fully float state shares was announced by the government. However, in practice, CSRC imposed certain lockdowns and restrictions on the amount of G-shares that could be sold.[443] As a result, the amount of non-tradable shares is still much higher than the amount of tradable shares. For example, in 2009, SOEs accounted for 49% of all shares on the Chinese stock market, of which 53% were still non-tradable, despite the reform four years earlier.[444] Consequently, the State retains a firm hold on these companies even when they are listed on a stock exchange. In fact the State holds these non-tradable shares**.**

In addition to many of the firms listed on the stock exchanges being state-owned, and to restrictions on a majority of the shares issued (since they are either non-tradable or not accessible to foreign investors), the access to the Chinese stock market is heavily regulated by

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[440] Allen, F., Qian, Q.J., Zhang, C. and Zhao, M. (2012). *China's financial system: opportunities and challenges*, NBER Working Paper Series, Working paper 17828, p.25.
[441] Price, A.H., Brightbill T.C., DeFrancesco R.E., Claeys, S.J., Teslik, A. and Neelakantan, U. (2017), *China's broken promises: why it is not a market-economy*, Wiley Rein LLP p.70.
[442] See http://www.sse.com.cn/market/stockdata/marketvalue/, accessed July 12, 2017.
[443] Article 27 of The Administrative Measure of Share Segmentation Reform of Listed Companies issued by the CSRC in September 2005 requires that (1) the non-tradeable shares ('NTSs') cannot be publicly traded or transferred within 12 months after the implementation of the reform proposal of NTSs adopted by the listed company; (2) with regard to these NTSs shareholders who own more than 5% shares of a listed company, after the expiration of the above required 12-month period, they are not allowed to sell more than 5% of shares converted from NTSs on a stock exchange within 12 months and are not allowed to sell more than 10% of shares converted from NTSs within 24 months.
[444] Allen, F., Qian, Q.J., Zhang, C. and Zhao, M. (2012). *China's financial system: opportunities and challenges*, NBER Working Paper Series, Working paper 17828, p.71.

the state. In contrast to other countries, IPOs do not simply need to be registered; they need to be approved by CSRC. The administrative control over the IPO procedure is thus high. Before 1999, share offerings were subject to a quota system. Although explicit quotas do not apply anymore, CSRC still applies implicit quotas for different districts and different industries.[445]

Officially, CSRC approval process is delegated to PORC, which makes a recommendation on the access to listing. PORC is comprised of a minority of CSRC officials and a majority of outside experts in law, accountancy and financial markets. The decisions of PORC may take into account all relevant considerations, including the issuer's qualifications, use of proceeds, legitimacy of business operation, competitive strength, assets quality, profit generating ability, independence, information disclosure and corporate governance. However, the CSRC can still decide to reduce or even stop for a certain period of time all pending IPOs regardless of their intrinsic investment quality.[446] For example, after the stock crash in 2015, the CSRC suspended all new offerings for about four months, until share prices began to recover.[447] In practice, the approval framework has tended to benefit the SOEs and large private enterprises with close ties to the government.[448]

One of the preconditions for an efficient securities market is the existence of reasonable protections for investors. The formal legal system of investor rights, i.e. the investors' rights to vote, to sell shares (thus facilitating a change in control) and to sue in China appears in many respects similar to shareholder rights in western systems. However, voting rights are restricted by the fact that in the majority of cases, block holders hold controlling blocks of shares. In SOEs, the controller is typically state affiliated; in the listed firms that are not SOEs, the controller is an individual, family or affiliated groups of investors.[449] Thus, for minority shareholders, corporate voting becomes irrelevant. In addition, given the existence of such controlling blocks, Chinese minority shareholders have little ability to ensure that they will receive dividends and no ability to force the sale of the firm that they collectively own.

As for the right to sue, Chinese courts have been authorized to treat claims of director wrongdoing in so-called 'derivative' lawsuits[450] since a 2006 amendment of the Company Law. However, for relatively small investors, the costs of such a lawsuit would be prohibitive, unless there was a mechanism to allow these costs to be shared among all other shares. Yet neither the statutory law nor judicial innovation allows such cost sharing. Thus, the few derivative cases that are found in modern Chinese law tend to be cases involving joint

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[445] Elliott, D.J. and Yan, K. (2013). *The Chinese Financial System, An Introduction and Overview*, John L. Thornton China Center at Brookings, Monograph Series, Number 6, July 2013, p. 24.
[446] Allen, W.T., Shen, H. (2011). *Assessing China's top-down securities markets*, NBER Working Paper Series, Working Paper 16713, p.17.
[447] Price, A.H., Brightbill T.C., DeFrancesco R.E., Claeys, S.J., Teslik, A. and Neelakantan, U. (2017). *China's broken promises: why it is not a market-economy*, Wiley Rein LLP p.72.
[448] Elliott, D.J. and Yan, K. (2013). *The Chinese Financial System, An Introduction and Overview*, John L. Thornton China Center at Brookings, Monograph Series, Number 6, July 2013, p.24.
[449] Allen, W.T., Shen, H. (2011). *Assessing China's top-down securities markets*, NBER Working Paper Series, Working Paper 16713, p.27.
[450] That is a suit brought by a shareholder in the name and for the benefit of the corporation itself.

ventures, where the plaintiff necessarily owns a large proportionate share of the firm. Thus despite the fact that formally Chinese law has adopted the investor initiated derivative suit, at this time courts are not in fact a realistic source of constraint on management misbehaviour in Chinese listed companies.[451]

As demonstrated above, this general weakness of shareholder rights discourages fundamental investment strategies. Since they cannot influence business choices, dividend levels, or investment decisions, shareholders rely less on the underlying firm value and focus more on speculative aspects of the stock price.

The Chinese stock market is at times rather speculative in nature and thus characterized by periods of relatively high volatility. In the recent past, there have been two periods of rapid expansion, followed by sudden crashes: one before the financial crisis of 2008 and one between 2014 and 2015. This volatility illustrates the fact that the market has difficulties in pricing securities adequately.

Furthermore, the stock market crash of 2015 clearly illustrates that the State also influences share prices through direct intervention. Indeed, during this crash, the government took a whole series of far-reaching countermeasures, including:

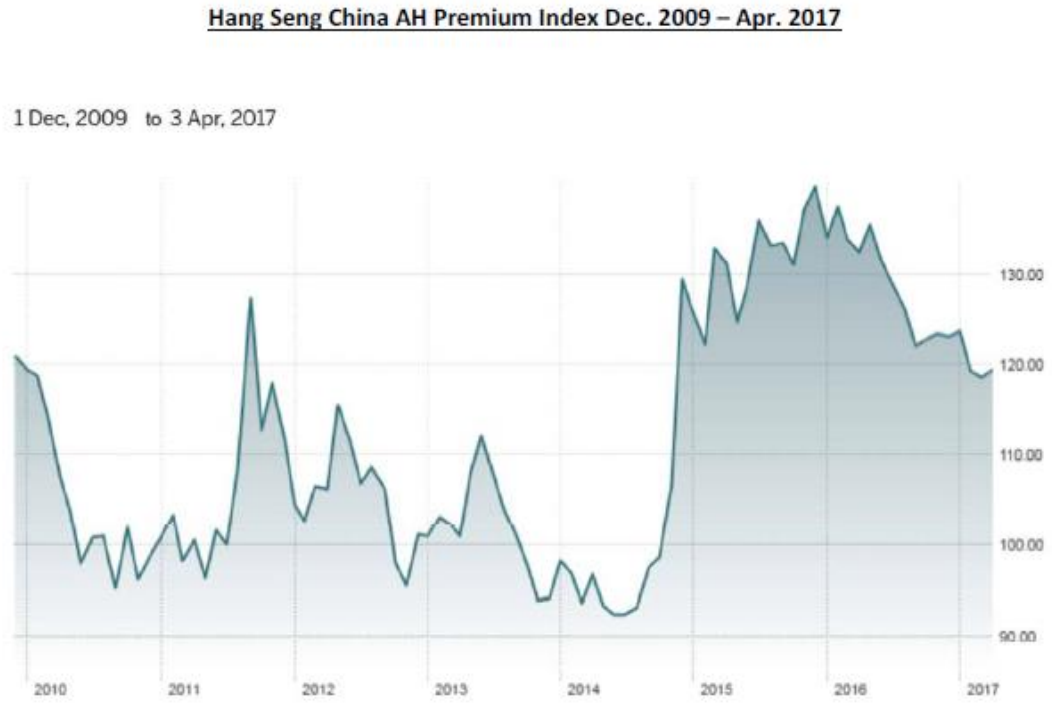
- An interest rate cut,
- A ban on major shareholders, corporate executives, directors from selling stock for 6 months,
- Use of large institutional investors to buy and hold shares. For example, the government organized a 'national team' led by Central Huijin Investment to purchase and hold shares. At one point, this national team owned up to 6% of the Chinese stock market.[452]
- Freezing more than half of the listed companies from trading,
- Blocking fund redemptions,
- Encouraging brokerage firms to buy stocks with cash from the People's Bank of China
- Halting IPOs,
- Reducing equity transaction fees,
- Providing daily bailouts to the margin lending authority,
- Reducing margin requirements,
- Capping short selling.[453]

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[451] Allen, W.T., Shen, H. (2011). *Assessing China's top-down securities markets*, NBER Working Paper Series, Working Paper 16713, p.34.
[452] Price, A.H., Brightbill T.C., DeFrancesco R.E., Claeys, S.J., Teslik, A. and Neelakantan, U. (2017). *China's broken promises: why it is not a market-economy*, Wiley Rein LLP, p.73.
[453] Colombo, J. (2015). *Watch These Charts To Better Understand China's Stock Market Crash.* Forbes, https://www.forbes.com/sites/jessecolombo/2015/07/12/watch-these-charts-to-better-understand-chinas-stock-market-crash/#6e97d7a61e8d (accessed on 28 November 2017); The Guardian. (2015). *Chinese stock markets continue to nosedive as regulator warns of panic* https://www.theguardian.com/business/2015/jul/08/china-stock-markets-continue-nosedive-as-regulator-warns-of-panic (accessed on 28 November 2017); The Economist. *(2015). China's stock market crash: a red flag*, http://www.economist.com/blogs/freeexchange/2015/07/chinas-stockmarket-crash, (accessed on 28/11/2017); Durden, T. (2015). *China Soars Most Since 2009 After Government Threatens Short Sellers With Arrest, Global Stocks Surge*. ZeroHedge.

As a result, Chinese stock markets have not been effective in allocating resources in the economy. This is clearly demonstrated when analysing the Hang Seng China A-H Premium Index. This index tracks the average price difference between A shares and H shares for the largest and most liquid China enterprises with both A-share and H-share listings. As these shares have the same voting and cash flow rights, they should follow each other closely in a properly functioning market.[454] Instead, the historical index shows substantial premiums for Chinese-traded A-shares in comparison with identical shares on the HKSE (see figure below). This demonstrates clearly that prices reflected on the mainland markets are not a good signal of fundamental value of the shares or the firms listed on the exchange.

Figure 14: Evolution of premiums for shares traded on Chinese stock exchanges in comparison with identical shares traded on the HKSE



Source: Price A.H., Brightbill T.C., DeFrancesco R.E., Claeys S.J., Teslik A., Neelakantan U., (2017), "*China's broken promises: why it is not a market-economy*", Wiley Rein LLP, p.71

In the above chart; 100 means that a Chinese A-share equals 100% of a Hong Kong H-share. Any figure below 100 means that the shares were traded at lower prices in China than in HK. Any figure above 100 means that the shares were traded at higher prices in China than in HK. Historically, one can see that prices in China were usually higher for the same shares, except in 2014, when there was a stock crash on the Chinese stock exchanges.

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http://www.zerohedge.com/news/2015-07-09/china-soars-most-2009-after-government-threatens-sellers-arrest-global-stocks-surge

[454] Allen, W.T., Shen, H. (2011). *Assessing China's top-down securities markets*, NBER Working Paper Series, Working Paper 16713, p.10.

6.6. INVESTMENT FUNDS

Until recently, the private equity market was not very concentrated. In 2010, around 3 500 private equity funds existed with total assets of around RMB 900 billion, of which 70% was funded from overseas.[455] Private equity investment is regulated by NDRC and MOFCOM, as well as by CSRC.

However, the government has recently started to enter the private equity market by establishing 'investment funds' that use public finances to invest in priority growth sectors. In November 2015 for example, MOF issued the Notice regarding Publication of the Provisional Measures for the Administration of Government Investment Funds,[456] according to which government finances should be used to *'invest in priority sectors for social and economic development'*. This is thus an innovative way to support industrial state policies.

For example, in order to implement the above-mentioned notice, the Chinese government established in 2015 and 2016 nine different government venture capital funds as subsidiaries of the already existing National Fund for Technology Transfer and Commercialization ('NFTTC').[457]

Furthermore, in September 2016, the government announced the launch of the China Structural Reform Fund, the country's largest private equity fund worth RMB 350 billion, in order to realize SOE restructuring by financing mergers, acquisitions, industrial upgrades and innovation in general.[458] This initiative has been taken in the context of the policy of deepening SOE reform (see Chapter 5.3).

Although the fund is labelled as being based on 'private' equity, it is actually funded and controlled by the state. The initial capital of the fund was raised by ten major SOEs, the fund is managed by SASAC via the state-owned China Chengtong Holdings Group, and the proceeds will be used for the restructuring of large-scale state-owned companies. The idea is to provide cheap capital to SOEs in comparison with standard bank loans, and to provide fresh money without increasing their debt ratio.[459]

Similar government investment funds have also been established in the context of Made in China 2025, such as the Advanced Manufacturing Fund, amounting to RMB 20 billion, and

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[455] Elliott, D.J. and Yan, K. (2013). *The Chinese Financial System, An Introduction and Overview*, John L. Thornton China Center at Brookings, Monograph Series, Number 6, July 2013, p.30.
[456] Notice regarding Publication of the Provisional Measures for the Administration of Government Investment Funds, MOF, Cai Yu [2015] No. 2010, issued November 12, 2015.
[457] See NFTTC, *Major Historical Events of the Fund* and *Introduction to the Fund*, available at http://www.nfttc.gov.cn/www/nfttc/212/index.html and http://www.nfttc.gov.cn/www/nfttc/209/index.html.
[458] Chang, L. (2016), *Massive fund to help reform giant SOE's*, China Daily, http://www.chinadaily.com.cn/business/2016-09/27/content_26904633.htm (accessed on 10 November 2017).
[459] Ibid.

the National Integrated Circuit Fund, totalling RMB 139 billion. These national level funds are complemented by a plethora of provincial level financing vehicles.[460]

In total, at the end of 2015, there were 780 state-linked investment funds with RMB 2.18 trillion in capital, and almost 300 of such funds, holding RMB 1.5 trillion, were established in 2015 alone.[461]

6.7. STATE PRESENCE IN THE EXPORT CREDIT INSURANCE MARKET

The China Export & Credit Insurance Corporation (commonly known as Sinosure) is a major Chinese SOE under the administration of SASAC specializing in export credit insurance, in particular to cover the export of high-value added goods from China. It has almost a monopoly in export credit insurance. Its premium income (export and domestic) in 2015 was RMB 16.5 billion. Another state-owned giant, PICC, was granted a license to underwrite such risks in 2013. However, it is believed that PICC remains very conservative in underwriting with limited premium income.[462]

Sinosure started operations in 2001. According to its website, it is mandated, *'in accordance with the Chinese government's diplomatic, international trade, industrial, fiscal and financial policies, to promote Chinese exports of goods, technologies and service, especially high-tech and high value-added capital goods like electromechanical products, and national enterprises' overseas investment, by means of export credit insurance against non-payment risks'* (emphasis added).[463] In addition, the website claims that *'through the service of policy-oriented insurance, Sinosure will continue to serve the state strategy and play more important policy role in supporting China's foreign trade development with the strategy of "go-abroad", safeguarding the security of national economy, and promoting the economic growth, the employment and the equilibrium of international balance of payment'*[464] (emphasis added).

Sinosure is wholly owned by the State, and the government exercises full ownership and financial control over it. Its registered capital comes from the venture fund of export credit insurance in line with the State finance budget. The Articles of Association state that '*the business competent department of the company is the Ministry of Finance'* and also requires

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[460] Wubbeke J. et al. (2016). *Made in China 2025: The Making of a High-Tech Superpower and Consequences for Industrial Countries*, Papers on China No. 2, Berlin: MERICS, p.7

[461] Center for Strategic and International Studies, (May 2016). *Perfecting China Inc.*, 27 (citing to Li Keqiang, *Report on the Work of the Government*, delivered at the Fourth Session of the 12th National People's Congress of the People's Republic of China, March 5, 2016).

[462] https://www.astreos-credit.com/single-post/2016/04/07/Overview-of-Credit-Insurance-in-China-2016 (accessed on 29 August 2017).

[463] http://www.sinosure.com.cn/sinosure/english/Company%20Profile.html (accessed on 29 August 2017).

[464] Ibid.

the company to submit financial and accounting reports and the fiscal budget report to MOF for examination and approval.[465]

All of the supervisors on Sinosure's Board of Supervisors are appointed by the State Council and execute their duties according to the Interim Regulation on the Board of Supervisors of Important State-owned Financial Institution. The senior management of Sinosure is also appointed by the government. The company's website shows that the Chairman of Sinosure is the Secretary of the Party Committee of Sinosure, and that the majority of senior management are also Members of the Party Committee of Sinosure.[466]

The 2014 annual report of Sinosure further confirms the influence of the State as '*Sinosure saved no effort in supporting China's national policies and sought to achieve this by exploring new ideas and concepts, improving working methods, perfecting products and services, as well as enhancing efficiency in performing its policy functions*' and states that it has a role as a '*policy-supportive organ'*.[467]

Significant in this respect is that China is not a signatory to The Arrangement on Guidelines for Officially Supported Export Credit of 1978 ('Arrangement'), that, amongst other things, prescribes a permitted range of Commercial Interest Reference Rates within which most OECD- based export credit agencies are permitted to lend. As Sinsosure is not bound by the Arrangement, it is able to provide insurance premiums at highly competitive rates compared with its OECD counterparts.[468] Sinosure itself takes pride in the support provided to Chinese exporters, stating that '*especially in times of financial crisis* […] *Sinsosure's policyholders were greatly helped in competing for orders and preserving their market share.* '[469]

As a result of the State support described above, export credit insurance in China is thus covered on favourable terms.

6.8. THE ROLE OF SHADOW BANKING IN CHINA

'*Shadow banks'* in China are financial firms that perform similar functions and assume similar risks as banks. However, they are not part of the formal banking sector. Definitions of the

[465] Council Implementing Regulation (EU) No 1239/2013 of 2 December 2013 imposing a definitive countervailing duty on imports of crystalline silicon photovoltaic modules and key components (i.e. cells) originating in or consigned from the People's Republic of China (OJ L 325, 5.12.2013, p. 66), recital 228.
[466] http://www.sinosure.com.cn/sinosure/english/Top%20Management.htm (accessed on 29 August 2017).
[467] Sinosure. (2014). *Annual Report*, p.4.
[468] Lee, H., Zhigang, L. and Coles, T. (2014). *Out of China: The activities of China's export credit agencies and development banks in Africa.* King & Wood Mallesons http://www.kwm.com/en/be/knowledge/insights/out-of-china-the-activities-of-chinas-export-credit-agencies-and-development-banks-in-africa-20160101 (accessed on 29 August 2017).
[469] See Sinosure company profile: http://www.sinosure.com.cn/sinosure/english/Company%20Profile.html (accessed on 29 August 2017).

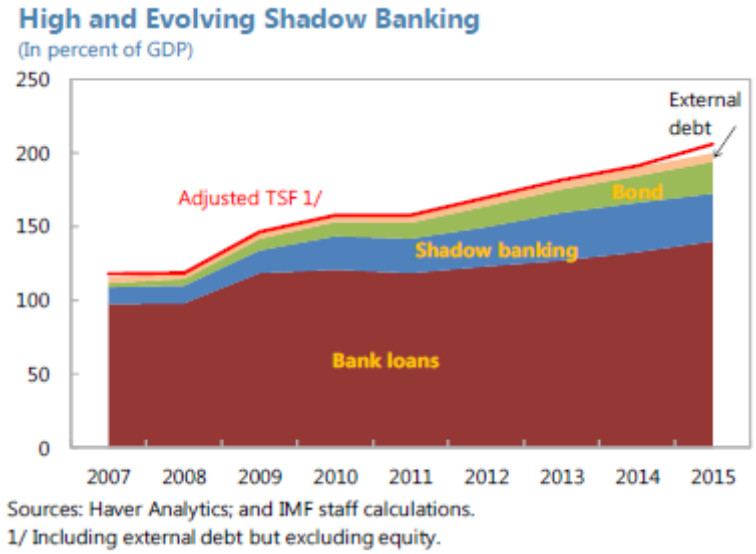
shadow banking sector vary, and can encompass any of the following institutions or instruments:[470]

- *Trust loans* are loans organised by trust companies, which are not considered banks. Trust companies combine elements of banks and asset managers. They can raise funds by issuing trust products, a form of securitized loan;
- *Entrusted loans* refer to loans made by non-financial firms to other firms (often within the same corporate group) that are channelled via the banking system for legal reasons, with banks indemnified from credit risk by the non-financial firm;
- *Banker's acceptances* are notes issued by banks promising a fixed payment in the future (usually a few months);
- *Financial leasing* involves all kind of leasing that is not a short-term operating lease;
- *Microfinance companies, e-financing (such as crowdfunding), pawn shops, guarantee companies*, and other unofficial lenders. Some of these lenders are officially registered and regulated, others are operating informally, and sometimes even illegally;
- *Wealth management products* are issued by brokers and banks. They are a form of collective investment where the funds raised are normally used to purchase assets such as bonds and equities on the secondary market rather than making direct loans. They are sometimes included in shadow banking because they are a close substitute for bank deposits.

There is a range of estimates on the size of China's shadow banking system, depending on the definition of shadow banking. Figures range from 8% to 80% of the size of GDP. Most studies however indicate a range between 30% and 50% of GDP.[471] Nevertheless, all studies agree that its size has increased relatively rapidly in recent years. However, it still remains substantially smaller than the formal banking sector, as can be seen in the graph below:

[470] Elliott, D., Kroeber, A. and Qiao, Y. (2015). *Shadow banking in China: A primer*, Economic Studies at Brookings, The Brookings Institution, p.7.
[471] Ibid., Appendix B, p.25.

Figure 15: Evolution of shadow banking



Source: IMF. (2016). *Resolving China's corporate debt problem*. IMF Working paper, WP/16/203, p.5.

The existence and growing importance of shadow banking is an indicator of the restraints and the tight control by the State on the official financial system. As was described above (see sections 6.2 and 6.4), both the formal banking sector and the bond market are dominated by state-owned players. Furthermore, the general legal framework encourages lending in line with industrial policies, preferably to certain 'encouraged' sectors. Finally, the restraints on access to the stock market make it difficult for firms that do not have government ties to raise money on a stock exchange. Thus the formal system is biased in favour of large and preferably state-owned entities. Smaller private players have difficulties to get access to capital and are thus forced to turn to unofficial forms of financing (this aspect is further developed in Chapter 11).

Furthermore, banks are restrained in the official system by caps on lending volumes imposed by PBOC, as well as by other capital and liquidity requirements.[472]. Such limits do not apply in the shadow banking system. A substantial portion of shadow banking in China is therefore also a form of 'bank loans in disguise', which allow the banks operating in the formal system to increase their loan activities through off-balance sheet transactions, without impacting their capital or NPL ratios. For example, banks can team up with trust companies to make loans to bank customers. This means that shadow banking on one hand adds needed flexibility to a rigid and distorted financial system, but that it also increases the risk of a debt crisis on the other hand.

[472] Elliott, D., Kroeber, A. and Qiao, Y. (2015). *Shadow banking in China: A primer*, Economic Studies at Brookings, The Brookings Institution, p. 5. See also: OECD, (2017). *OECD Economic Surveys: China 2017*, OECD Publishing, Paris, p. 14.

6.9. BANKRUPTCY PROCEDURES

China's first bankruptcy law, passed in 1986, concerned only SOEs and had little impact in practice. China's corporate bankruptcy law was revised in 2006, following the restructuring of China's SOE sector in the early 2000s. The new Enterprise Bankruptcy Law of the People's Republic of China [473] (hereafter 'the Bankruptcy Law') is effective as of 1 June 2007.

6.9.1. CHINA'S BANKRUPTCY LAW OF 2006

The Bankruptcy Law applies to enterprises with a legal person status, including financial institutions,[474] as well as other organizations falling under liquidation procedures.[475] Thus the Law applies to all companies, SOEs and private alike (except partnerships and sole proprietorships[476]). It is important to mention that in the case of financial institutions only the relevant financial supervisory/regulatory authority may file for their bankruptcy; if a financial institution is considered insolvent, the State Council itself can formulate the measures to carry out liquidation.[477]

An indebted entity as qualified above is subject to the Bankruptcy Law if: (1) the debtor cannot pay off the current debts due and his or her assets are insufficient to repay all of the debts; or (2) when the debtor apparently lacks the ability to repay his or her debts.[478] The Bankruptcy Law does not give any further details on how to determine whether a debtor falls into one of these categories, despite some interpretation that was provided by the Supreme People's Court.[479]

Both the debtor and its creditor(s) can apply for reorganisation or liquidation by filing to a Chinese court.[480] When the filing is made by the creditor, the debtor has 7 days for opposing the process after being notified by the court.[481]

A specific rule in Article 10 of the Bankruptcy Law empowers the relevant court to accept or reject the insolvency case within 15 days (extendable to 15 additional days subject to approval

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[473] Enterprise Bankruptcy Law of the People's Republic of China, Order of the President of the People's Republic of China nr. 54, 27 August 2006.
[474] According to Article 134 'financial institutions' in the meaning of the Law consist of: commercial banks, securities companies, insurance companies or any other financial institution.
[475] Bankruptcy Law, Articles 2, 134 and 135.
[476] For details see the website of CSRC, http://www.csrc.gov.cn/ (accessed on 15 November 2017).
[477] Bankruptcy Law, Article 134.
[478] Ibid., Article 2.
[479] Provisions of the Supreme People's Court on Certain Issues concerning the Application of the Enterprise Bankruptcy Law of the People's Republic of China (1), Notice of 9 September 2011. http://old.chinacourt.org/public/detail.php?id=465467
[480] Bankruptcy Law, Article 7.
[481] Ibid., Article 10.

by a court of higher instance). This results in certain consequences described further below. The court's rejection of the filing can be challenged by the petitioner.[482]

With the acceptance of the case, all judiciary measures for preserving the property are suspended and so are the related execution, civil and arbitration proceedings,[483] as well as debt repayments.[484] The suspension in question will however have no effect until the court accepts the case during the imparted 15 days, and therefore during that period the debtor's property is vulnerable to all proceedings above. Additionally, it is also worthwhile noting that if the case is accepted by the court as a reorganisation, the realisation of secured creditor rights is likewise suspended, unless overturned by the court at the secured creditor's request when the fate or value of its assets is at risk. [485]

When the court accepts the case, it appoints an administrator to carry out an extensive range of responsibilities related to running the reorganisation/liquidation process and managing the debtor's property, which includes – among others – deciding upon the closure or continuation of business operations before a creditors meeting (subject to a court approval) or upon the annulment or continuation of business contracts entered into by the debtor prior to a case opening.[486] The administrator is also empowered to request the court to nullify certain transactions which were conducted by the debtor within the last one year (or six months, depending on the case) before the acceptance of the bankruptcy case.[487] It is however worthwhile mentioning that during a reorganisation process, the debtor may be authorized by the court to take back control of his property and business operations management (however under the supervision of the administrator).[488]

The appointed administrator can be '*a person who has the necessary professional knowledge and has obtained the qualifications for the practice to serve as an administrator'* or can consist of a '*liquidation team composed of persons of the departments or authorities concerned*'[489] or be '*a law firm, a certified public accountant firm, a bankruptcy liquidation firm or any other public intermediary agency that is established according to law*'.[490] Such

[482] Ibid., Article 12.
[483] Civil and arbitration actions are stayed until the administrator effectively takes custody of the property - with civil cases being after that only handled by the court in charge of the bankruptcy proceedings (see Bankruptcy Law, Articles 20 and 21).
[484] Ibid., Articles 16, 19 and 20.
[485] Ibid., Article 75.
[486] Ibid., Articles 13, 22 and 25.
[487] Ibid., Articles 31 and 32.
[488] Ibid., Article 73.
[489] The institution of 'liquidation team' is a remnant of the previous Chinese Bankruptcy Law of 1986. Under that Law it applied to SOEs and consisted of local officials supervising the liquidation process. It was included in the Law of 2006 allegedly under the pressure of local authorities - see Gao S. and Wang, Q. (2017). *The U.S. Reorganization Regime in the Chinese Mirror: Legal Transplantation and Obstructed Efficiency*, American Bankruptcy Law Journal, vol. 91, issue 1, p. 27.
[490] Bankruptcy Law, Article 24.

provisions make it therefore possible for the administrator to originate in the public administration.

The administrator is picked randomly from a roster of administrators. The Chinese courts retain exclusive rights to draw that list, and therefore it can be assumed that the administrator's choice is at the full discretion of the Chinese judiciary.[491] The same applies with regard to the level of the administrator's remuneration as the court also decides on the latter upon his or her appointment, and the amount of the fees can be challenged by the creditors – again – before the court.[492] On the other hand, it is useful to point out that the administrator's activity is subject to the control of the creditors' meeting and committee.[493]

Creditors concerned with the insolvency case gather in a creditors meeting, where those having their claims formally confirmed are permitted to vote on the case matters.[494] The meeting's function – among others – is to give a final shape to the claims, to supervise the work of the administrator, including deciding on his or her dismissal, to decide on the fate of the debtor's business operations and – most importantly – to discuss and adopt plans for reorganisation, for property distribution, or for compromise deals.[495]

The meeting of creditors is empowered to establish, further to the court's approval, a creditors' committee – a central element of today's Chinese insolvency processes (see 6.9.2). Such committee of up to nine persons consists of the creditors' representatives, chosen by the meeting, as well as a delegate of the company's staff or the trade unions.[496] The committee's formal function is to supervise the management and distribution of the debtor's property, but the committee can also be entrusted with any other role by the creditors' meeting.[497] The administrator is bound to report to the committee ahead of its decisions related to the management of the debtor's business operations or assets (otherwise, in the absence of a committee, he or she reports to the court).[498] It is also important to add that while supervising the whole insolvency process, the committee can moreover request to convene a creditors meeting, which in turn can lead to a vote on key decisions enumerated above.[499]

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[491] *Regulation of the Supreme People's Court on the appointment of administrators in enterprise bankruptcy cases*, promulgated on 12 April 2007.
http://law.npc.gov.cn/FLFG/flfgByID.action?txtid=3&flfgID=243802&showDetailType=QW
[492] Bankruptcy Law, Article 28.
[493] Ibid., Article 23.
[494] Ibid., Article 59.
[495] Ibid., Article 61.
[496] Ibid., Article 67.
[497] Ibid., Article 68.
[498] Ibid., Article 69.
[499] Ibid., Article 68.

In case of bankruptcy, the liquidation of the debtor's assets is carried out in the following order of claims:

- creditors' claims which are secured by the debtor's property,
- expenses related to insolvency proceedings,[500]
- liabilities of common interest,[501]
- liabilities to the employees, including: wages, sickness and disability allowances and pensions; old-age insurance, health insurance and social security premiums; and any other compensation owed to the employees or unpaid tax related thereto.
- claims by other unsecured creditors. [502]

If the debtors' assets are insufficient to cover the proceedings costs, the administrator can request the court to terminate the case.[503] If these assets do not cover the claims for a similarly-situated group of creditors, they are distributed to the latter on a pro rata basis.[504] Regarding the above order of distribution of the assets, it is here relevant to note that Article 6 of the Bankruptcy Law binds the court to *'guarantee the legitimate rights and interests of the employees of the enterprise*'.

In case a reorganisation is ruled by the court, the creditors meeting discusses and votes on a restructuring plan, based on a double majority system – requiring the assent of half of the number of creditors concerned, representing at least 2/3 of the debt of the creditors concerned.[505] When adoption is not possible in such process, another vote may be held after consultations with the debtor or the administrator. If as a consequence a plan would still not have been adopted, the matter can be referred to the court by the administrator or the debtor for acceptance, under certain conditions.[506] This latter provision gives therefore a prerogative to bypass the will of the creditors in a restructuring process, with consequences presented below.

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[500] These costs are: the litigation cost involved in a bankruptcy case; expenses for management, realisation and distribution of the debtor's property; and expenses related to the administrator's performance of his duties and paid for his remuneration and expenses for the employees recruited. See Bankruptcy Law, Article 41.
[501] These debts are: the debts incurred because of the administrator's or debtor's requests to another party to fulfil a contract which both parties have failed to fulfil; debts to the debtor through voluntary service on the debtor's property; debts incurred as a result of the debtor's unjust enrichment; remunerations for work and social insurance premiums payable for sustaining the debtor's business operations, and other debts arising therefrom; debts incurred from the administrator's or an employee's losses caused to another person in the course of performing his duties; and debts incurred from losses caused by the debtor's property to another person. See Bankruptcy Law, Article 42.
[502] Ibid., Article 113.
[503] Ibid., Article 43.
[504] Ibid.
[505] Ibid., Article 84.
[506] Ibid., Article 87.

6.9.2. IMPLEMENTATION OF THE BANKRUPTCY LAW

As described above, in many aspects the current Chinese law is similar to bankruptcy laws in Western countries. It leads to either liquidation or reorganisation, and it relies on the intervention of the court, as well as of an administrator, who manages the assets of the debtor after the court has accepted the bankruptcy filing. Moreover, the law states that these administrators should be independent professionals.[507] Likewise, creditors are by law normally able to decide the outcome of the insolvency process.

Despite this, the number of insolvency cases has been very small for the size of the Chinese economy, only a few thousand per year on average.[508] Even tough in 2015 and 2016 the numbers increased (3 568 and 5 665 respectively),[509] during the years following the entry into force of the Bankruptcy Law they have been on a downward trend until 2013,[510] despite worsening economic conditions. In comparison to these figures, in 2016 courts in France registered 57 844 insolvency filings (with even slightly higher numbers in previous years),[511] while statistics in Germany reveal 21 518 business bankruptcies for the same year.[512] In fact, as demonstrated below, many insolvent firms in China are kept afloat, and almost all the listed firms that file for bankruptcy end up with restructuring plans and these firms are rarely delisted.[513]

The reasons of such state of affairs are related to a certain extent to some shortcomings of the Law, and – more importantly – to the broad decisional discretion that the Chinese courts have in the insolvency process (via the Bankruptcy Law itself) and the far-reaching influence of State authorities (via jurisprudence and practice pursuing political and policy objectives) on the fate of failing companies subject to bankruptcy procedures.

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[507] Allen, F., Qian, J., Zhang, C. and Zhao, M. (2012) *China's financial system: opportunities and challenges*, Working Paper 17828, National Bureau of Economic Research, Cambridge, February 2012, p. 6. http://www.nber.org/papers/w17828

[508] Jiang Y., (2014). *The curious case of inactive bankruptcy practice in China: A Comparative Study of U.S. and Chinese Bankruptcy Law*, Northwestern Journal of International Law & Business, vol. 34, issue 3, p. 561. See also Maliszewski, W., et al. (2016). *Resolving China's corporate debt problem*, IMF Working Paper WP/16/203.

[509] Bloomberg News. (2017). *Chinese Leaders Back Bankruptcies for Unwanted Zombie Firms*, https://www.bloomberg.com/news/articles/2017-03-13/chinese-leaders-back-bankruptcies-for-unwanted-zombie-companies. See also Luo, S. (2016). *Handling bankruptcy cases in accordance with law and duly process 'zombie enterprises' – an Interview with Du Wanhua, a full-time Member of the Judicial Committee of the Supreme People's Court'*, People's Court News, Second Edition, http://www.chinacourt.org/article/detail/2016/04/id/1846021.shtml (accessed 22 November 2017).

[510] Supreme People's Court Monitor. (2016). *Ramping up China's bankruptcy courts, the latest data.* https://supremepeoplescourtmonitor.com/2016/05/18/ramping-up-chinas-bankruptcy-courts-the-latest-data/ (accessed 22 November 2017).

[511] Altares Data. (2017). *Bilan 2016 - Défaillances et sauvegardes d'entreprises en France*.

[512] German Federal Statistical Office (Destatis) data: https://www.destatis.de/EN/FactsFigures/Indicators/ShortTermIndicators/Insolvencies/ins110.html

[513] When a listed firm is in distress, typically other (non-listed) firms will restructure the listed firm to avoid delisting, since the 'shell' of the distressed firm can be used to avoid the difficult IPO process, as described in the section above.

Firstly, certain procedural defaults in the provisions of the Chinese Bankruptcy Law described already above are possibly part of the reason for the low numbers of effective insolvency filings and/or cases:

- Standards for determination of bankruptcy are vague. For example, the criteria for determining a company's lack of assets to pay off its debts can be difficult to prove, and such determinations remain at the full discretion of the court.

- In spite of the existence in the Law of automatic moratorium provisions (and the administrator's right to seek repayment from creditors who have received payments within the previous six months), there is a 15-day window between a filing and the court's acceptance of a case, during which creditors may often seek to collect on their debts. This can lead to a so-called 'creditors' race', in which creditors with knowledge about the filing will increase efforts to reclaim their amounts due, often endangering the integrity of the debtor's assets to be made subject to a restructuring or distribution. This represents an important disincentive for bankruptcy filings.[514]

- Once a case is accepted, the court has considerable discretion in the appointment of insolvency administrators. In reality, administrators are often connected to local governments. As mentioned above, according to Article 24 of the Bankruptcy Law, the court can designate representatives of the local government directly to a liquidation team, which acts as an administrator.[515] A study from 2012 showed that 45% of administrator appointments came from these liquidation teams.[516] According to the same study, in 40 out of 70 reorganisation proceedings, the appointed administrator was in fact a government-related liquidation team. Moreover, in the remaining 30 cases, 18 reorganisations were allegedly carried out with the administrator being assisted by 'special working teams' issued from local authorities. Therefore, in 58 out of the 70 proceedings studied the local government had potentially influenced the reorganisation process through the administrator or a related body.[517]

- An insolvency process appears also to present additional risks for debtor's management staff, as they may be held liable under the law and incur civil penalties.[518] This translates, among others, into possible worries from parties involved that the insolvency process might lead them to face possible accusations of mismanagement of state assets.[519]

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[514] Jiang Y. (2014). *The curious case of inactive bankruptcy practice in China: A Comparative Study of U.S. and Chinese Bankruptcy Law*, pp. 559-582, p.570.
[515] Ibid., p.573 and 576.
[516] Tomasic, R. and Zhang, Z. (2012). *From Global Convergence in China's Enterprise Bankruptcy Law 2006 to Divergent Implementation: Corporate Reorganisation in China*, Journal of Corporate Law Studies, 12:2, p.313.
[517] Ibid., p.315.
[518] Bankruptcy Law, Articles 125 to 129.
[519] OECD (2017). *OECD Economic Surveys: China 2017*, Paris: OECD Publishing, p. 41. http://dx.doi.org/10.1787/eco_surveys-chn-2017-en (accessed on 29 August 2017).

- In addition, in the spirit of Article 6 of the Law and the SPC's jurisprudence,[520] courts require debtors to present solutions for the employees. This also has the potential to discourage debtors from filing for insolvency.

Secondly, besides the issues enumerated above, the courts and the State play a very active role in Chinese bankruptcy proceedings, often seriously influencing or altering their outcome, which is illustrated by the various elements below:

- As already pointed out, Chinese courts have considerable discretionary power in the commencement of bankruptcy cases: the courts decide whether a bankruptcy filing will be accepted or not, and the standards for approval are not precise. For example, the conditions for starting a possible case – i.e. a company's lack of assets to pay off its debts – can be difficult to prove. Likewise, the court can impose a reorganisation pattern, if creditors do not reach a compromise. In general, all important steps or decisions in a Chinese insolvency procedure are subject to the control and approval of the judiciary.

- Furthermore, not only do the courts play a crucial role in the insolvency system, but they may also lack independence (see Section 3.4.4). For example, through a key judiciary opinion of the Supreme People's Court of 2009, Chinese courts were encouraged to cooperate with local governments to solve issues arising in bankruptcy cases, by *'adhering to the local Party Committees' guidance, [and] striv[ing] to ensure stability in enterprise bankruptcy cases in coordination with governmental action'*.[521] Furthermore, courts are requested to work with local governments to coordinate with the banks in case of reorganization proceedings. The influence and support of the local authorities appears therefore as a key element in insolvency or reorganization filings, which is confirmed by Chinese scholars' legal interpretations.[522]

- As a result of the above, courts are, for example, reluctant in accepting filings against SOEs. The case of East Star Airline Co Ltd is a famous example of the influence of local government on court decisions: the court reportedly refused to accept the company's application for reorganization due to the interference of the Wuhan Municipal Government.[523] The local government also initiated a criminal investigation against the CEO of East Star Airline's claiming that '*he did not listen to local officials in terms of the previously proposed pre-packaged insolvency plan'*.[524] In the same case, the administrator

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[520] See Opinion of the Supreme People's Court on various questions related to the correct handling of enterprise bankruptcy cases so as to maintain the market economy order and provide judicial guarantees. Notice no. 36 [2009] of 12 June 2009. http://www.court.gov.cn/shenpan-xiangqing-370.html
[521] Ibid.
[522] See Wang, J. and Zhang, D. (2010). *Reflection on the approval system of bankruptcy and reorganization plans,* People's judicature, Issue 23, p. 52. http://www.pkulaw.cn/fulltext_form.aspx?Db=qikan&Gid=1510117145 (accessed 28 September 2017).
[523] Jiang, Y. (2014). *The Curious Case of Inactive Bankruptcy Practice in China: A Comparative Study of US and Chinese Bankruptcy Law.* pp. 559-582, p.581.
[524] Tomasic, R. and Zhang, Z. (2012). *From Global Convergence in China's Enterprise Bankruptcy Law 2006 to Divergent Implementation: Corporate Reorganisation in China*. p. 322.

acted in line with the local government (with the final support of the court), by allegedly opposing the efforts of both the creditors and the debtor to save the company. Many similar cases are described in publications.[525]

- It should also be mentioned that the approval of the relevant provincial government, the Supreme People's Court, and CSRC are required to accept a bankruptcy case affecting a listed company.[526] This can trigger such bankruptcy petitions to be frequently dismissed or ignored.

- As pointed out, a separate regime governs the bankruptcy of financial institutions, which are shielded from the normal insolvency procedures of the Bankruptcy Law. The banks' ultimate fate in that respect is therefore in the hands of the State Council, which is empowered to adopt bankruptcy implementing measures in that case.[527] However, the Bankruptcy Law does not provide more details of the latter process. The effect of this legal set-up is that, as reported recently by a chief analyst at People's Bank of China, since the entry into force of the new insolvency system in 2007 no Chinese bank has formally defaulted.[528] According to various sources, insolvency rules for financial institutions have simply been non-existent until 2017.[529] Certain such provisions are said to be possibly in preparation by the CBRC, without however their effect being known.[530]

- The active role of courts and local governments is reflected in their control over reorganisation processes.[531] First of all, access to the latter (instead of liquidation) has been mainly granted to state-owned firms and large listed firms.[532] Secondly, reorganisation plans are often negotiated outside of the court proceedings, and/or under the direct influence of - or even by - the local authorities.[533] In addition, as mentioned already, the law provides broad powers for the court to accept reorganisation plans against the will of dissenting creditors. As a result, despite the legal protection of creditors' interests and the existence of a creditors' repayment hierarchy, the result of a

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[525] Jiang, Y. (2014). *The Curious Case of Inactive Bankruptcy Practice in China: A Comparative Study of US and Chinese Bankruptcy Law*. pp. 579-581.
[526] *Summary of the Panel Discussion on Trial of Bankruptcy and Reorganization Cases of Listed Companies*, Supreme People's Court, 29 October 2012, available at: http://www.csrc.gov.cn/pub/newsite/flb/flfg/sfjs_8249/201312/t20131205_239353.html.
[527] Bankruptcy Law, Article 134
[528] Tang, F. (2017). *Many financial institutions should go bust, China central bank researcher says*. South China Morning Post, 12 May 2017.
[529] Jiang, X. (2017) *China's banking regulator drafting bankruptcy rules*. China Daily. 10 August 2017. See also: OECD (2017). *OECD Economic Surveys: China 2017*. p.41
[530] Ibid.
[531] In the case of governmental influence: see Tomasic, R. and Zhang, Z. (2012). *From Global Convergence in China's Enterprise Bankruptcy Law 2006 to Divergent Implementation: Corporate Reorganisation in China*. pp. 316-324.
[532] Ibid., p.312-314.
[533] See Maliszewski, W., et al. (2016). *Resolving China's corporate debt problem*, p.16. See also Tomasic, R. and Zhang, Z. (2012). *From Global Convergence in China's Enterprise Bankruptcy Law 2006 to Divergent Implementation: Corporate Reorganisation in China*. p. 319, p. 328.

reorganisation process will vary depending on the court's interpretation and/or – what is more – on the will of the local authorities.

- Indeed, bankruptcy courts proceedings generally need the go-ahead of local authorities. The latter are under pressure of potential social unrest which could be caused by sacked or displaced workers. Therefore the local government will often be interested in influencing the bankruptcy proceedings so that an agreement on accommodating the workers' needs is reached. [534]

- This, in turn, goes hand in hand with a broader State approach towards SOE bankruptcies consisting of guiding any insolvency proceeding towards a merger or reorganisation rather than liquidation. One basis of this approach is the already-cited Opinion of the Supreme People's Court from 2009. The latter instructs the courts that even in the case of companies which have already been or are at present threatened with insolvency, the judges should look into the possibility of avoiding a default by rather having recourse to restructuring and conciliation to revive the troubled company, should such company be judged to still have potential development prospects and meet the conditions of overarching policies on the adjustment of the local industrial structure.[535] This makes it formally possible to keep alive companies which, while no longer viable, belong to sectors supported or promoted by the State.

- Another foundation of the current Chinese policy of bankruptcy avoidance is the principle promulgated by CBRC, compelling creditors (usually banks) to handle and solve the debt problems of major debtor companies through creditors' committees (see Section 6.9.1). Beyond the provisions of the Bankruptcy Law, CBRC established additional rules governing such committees, with the aim of making them a central instrument in charge of relieving ailing companies from their debts. According to these rules, the committee consists of three or more creditors (usually financial institutions). It is reportedly set up and led by the largest creditors. It is bound to play the role of a platform of exchange of views between creditors and a vehicle of negotiation with the indebted company with a restructuring plan as the final outcome. The committee functions on the basis of a 'creditor agreement' fixing the debt structure, rules of procedure, members rights and obligations as well as all related functioning costs. While normally decisions must be made by a majority of creditors, representing two-thirds of the company's debt, it is recommended that the committees' decisions are taken by consensus. The committee's vocation is both to keep the company alive, through managing the debt by creditors' compromises, while working out a reorganisation plan. The goal is to preserve the assets

[534] Allen, F., Qian, J., Zhang, C. and Zhao, M. (2012). *China's financial system: opportunities and challenges*, Working Paper 17828, National Bureau of Economic Research, Cambridge, February 2012, p. 21. http://www.nber.org/papers/w17828.

[535] See Opinion of the Supreme People's Court on various questions related to the correct handling of enterprise bankruptcy cases so as to maintain the market economy order and provide judicial guarantees. Notice no. 36 [2009] of 12 June 2009. http://www.court.gov.cn/shenpan-xiangqing-370.html

and reconcile the interests of both banking institutions and the company at the same time, but – more importantly – by remaining in line with 'national macroeconomic, industrial and support policies'. In that process, the creditors are advised to avoid recalling loans in advance or ceasing lending to the company.[536]

- The Chinese corporate debt is currently nationally managed by more than 12 000 creditors' committees and said to reach RMB 14.85 trillion according to CBRC statements.[537] The policy regarding the committees is supervised by the CBRC's local branches. As an example, the Henan Office of CBRC praised itself in March 2016 for monitoring committees which served 535 companies (each with debts of more than RMB 300 million), and half a year later for supervising 1 300 companies – with a debt handled equivalent to 55% of the corporate debt of the region,[538] while CBRC's office in Heilongjiang province admitted in May 2017 to overseeing committees managing the debt of 155 SOE companies.[539]

- It appears from various media reports on insolvency proceedings that creditors' committees are, under the veil of consensus-building, a vehicle for avoiding exaggerated claim activity by certain groups of creditors in their quest for repayments. This happens very often with the support of local governments, which naturally prefer to avoid social issues linked to bankruptcy and lay-offs as well as financial trouble linked to the loss of tax revenues[540]. Such cases result often in the borrowing banks being pushed into forced cooperation in the restructuring process via the granting of further loans or the acceptance of debt-to-equity swaps. Reported examples of proceedings where creditors' interests have been overridden in order to save a company from failing are those of Feicheng Mining group,[541] Dongbei Special Steel Group,[542] Huishan Dairy[543] or Sinosteel.[544]

As presented above, enforcement of the Bankruptcy Law remains overall weak and inconsistent. The low reliance on formal bankruptcy also goes along with the absence of

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[536] CBRC notice 1196 of 6 July 2016. http://www.cbrc.gov.cn/chinese/home/docView/B5ECBFFA160946E480E50A319600A294.html. See also: Jiang, X. (2016). *Regulator calls for banks to form creditors' committees*, China Daily, 9 September 2016. http://www.chinadaily.com.cn/business/2016-09/09/content_26754808.htm. (accessed on 6 October 2017).
[537] See Jiang X. (2016). *Regulator calls for banks to form creditors' committees.* China Daily.
[538] Ibid. See also: Zhang,, S. and Miller, M. (2017) *China tries cure by committee for corporate debt hangover*. Reuters. http://www.reuters.com/article/us-china-debt-restructuring/china-tries-cure-by-committee-for-corporate-debt-hangover-idUSKBN16F0AF (accessed on 9 October 2017).
[539] Wildau G. (2017). *Regulator urges China banks to save ailing companies*. Financial Times. 26 May 2017. https://www.ft.com/content/5455689c-41c7-11e7-9d56-25f963e998b2 (accessed on 22 September 2017)
[540] Wildau G. (2017). *Regulator urges China banks to save ailing companies*. Financial Times, 26 May 2017.
[541] Zhang, S. and Miller, M. (2017). *China tries cure by committee for corporate debt hangover*. Reuters, 8 March 2017.
[542] Zhang, Y. and Dong, T. (2017). *Steel company's restructuring draws creditor ire.* Caixin, 28 August 2017. https://www.caixinglobal.com/2017-08-28/101136917.html (accessed on 9 October 2017).
[543] Tang, F. (2017). *Until it breaks: China debt risks exposed after 85pc fall in dairy firm's stock price*. South China Morning Post, 29 March 2017. http://www.scmp.com/news/china/economy/article/2082787/until-it-breaks-china-debt-risks-exposed-after-85pc-fall-dairy (accessed on 9 October 2017).
[544] Maliszewski, W. et al. (2016). *Resolving China's corporate debt problem*. p. 30.

defaults on corporate bonds issuance by SOEs, with the first such default occurring as late as 2015,[545] while the first private default occurred in 2014.[546] While there has since been a rise in defaults or near-defaults, these instances have been handled on a case-by-case basis with differing degrees of state intervention and transparency,[547] and do not seem to promote corporate liquidation. For example, an IMF listing of 10 near-default cases between mid-May 2014 and May 2016 showed that ultimately only one company went into liquidation. The others secured continuity of operations via various means, such as debt restructuring, bailout loans, capital injections or takeover of the bonds by the parent company, as well as direct State intervention.[548]

The current state of affairs described above and the relatively rare occurrence of insolvencies, especially in relation to SOEs, has two important effects. First of all, as demonstrated in other chapters of this Report, the practice of keeping companies alive at all cost (for reasons enumerated in this section) results in the survival of large numbers of unviable companies, which contributes to the persistence of unused production capacities, with all the subsequent negative economic consequences for China and its export markets.[549]

Secondly, the relatively low reliance on bankruptcy proceedings which would result in SOEs' failures creates a specific market perception of the corporate fabric in China which reverberates in Chinese financial and borrowing markets. Indeed, the governmental and judiciary-induced practice of keeping companies alive amounts to granting implicit State guarantees to these companies. As acknowledged by specialized economic publications, this in turn distorts downwards the costs of credits and of access to finance, and results in vast amounts of loans received by State-related firms at attractive rates, at the expense of private players.[550] It contributes to a spiral of indebtedness via the constant rolling-over of (mostly inefficient) loans to 'zombie companies', which affects at the same time the viability of the

[545] Taplin, N. and Sweeney, P. (2015). *China sees first state-owned firm default on bond.* Reuters, 21 April 2015. https://www.reuters.com/article/china-debt-bonds/china-sees-first-state-owned-firm-default-on-bond-idINKBN0NC0RS20150421 (accessed on 21 November 2017)
[546] Gittleson, K. (2014). *Chaori Solar in landmark Chinese bond default.* BBC News, 7 March 2014. http://www.bbc.com/news/business-26464901 (accessed on 21 November 2017)
[547] Price A.H., Brightbill, T.C., DeFrancesco, R.E., Claeys S.J., Teslik A. and Neelakantan U. (2017). *China's broken promises: why it is not a market-economy*. Wiley Rein LLP, p. 69
[548] Maliszewski, W. et al. (2016). *Resolving China's corporate debt problem*. pp. 30-31.
[549] See the relevant sections in this Report and in: European Chamber of Commerce in China. (2016). *Overcapacity in China – an impediment to the government's reform agenda*.
[550] Balding, C. (2017). *China takes on State-owned firm.* Bloomberg News, 10 August 2017. https://www.bloomberg.com/view/articles/2017-08-10/china-takes-on-state-owned-firms. See also: *A moral deficit.* The Economist, 18 October 2014. https://www.economist.com/news/finance-and-economics/21625823-rein-its-debt-china-must-be-willing-let-companies-fail-moral-deficit. See as well: Anzoategui, D., Chivakul, M., and Maliszewski, W. (2015). *Financial Distortions in China: A General Equilibrium Approach*, IMF Working Paper WP/15/274, pp. 5-8. http://www.imf.org/external/pubs/ft/wp/2015/wp15274.pdf

Chinese banking system.[551] Chinese financial institutions, however, as specified above, are shielded from normal insolvency procedures under the Bankruptcy Law.

6.10. CHAPTER SUMMARY

This chapter has described the continuity between the government and all major aspects of the financial system in China. This reflects a distorted situation which is *de facto* not comparable to other market-based economies.

Despite a number of transformations throughout nearly three decades, the current Chinese financial system is still characterized by two features: (1) a strong presence of state-owned banks and (2) a widespread influence of the State which imposes on the financial system a number of policy objectives, in particular for the implementation of its sophisticated economic planning system.

The most important categories of banks in China are the following: large commercial banks, joint-stock commercial banks and policy banks. Together they accounted in 2015 for 68% of the total assets of the banking institutions. The rest is mainly accounted for by smaller rural or city commercial banks which are mostly owned by local or provincial governments. Foreign-invested banks remain negligible in China's banking sector.

Furthermore, available information suggests that Chinese banks are the largest holders of corporate bonds issued by the Chinese state-owned sector. In terms of management of the banks, generally speaking, the top executives of the large state-owned financial institutions are ultimately appointed by the Organisation Department of the CCP and many of the board of directors' seats are assigned to professionals who are connected to the government apparatus.

The legal framework spells out that banks are instruments in order to implement China's economic policy. Article 1 of the Banking Law stipulates, inter alia, that banks promote the development of the socialist market economy and Article 34 states that '*[c]ommercial banks shall conduct their business in accordance with the needs of the national economic and social development and under the guidance of the industrial policies of the State*'. Decision No 40 and the Securities Law also contain provisions to a similar effect.

While it is acknowledged that various legal provisions refer to the need to respect normal banking behaviour and prudential rules such as the need to examine the creditworthiness of the borrower, the overwhelming evidence including findings made in trade defence investigations suggests that these provisions play only a secondary role in the application of the various legal instruments.

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[551] Anzoategui, D., Chivakul, M., and Maliszewski, W. (2015). *Financial Distortions in China: A General Equilibrium Approach*, IMF Working Paper WP/15/274, pp. 5-8.

The functioning of the entire financial system points to significant distortions. Bond and credit ratings are often distorted for a variety of reasons including the fact that the risk assessment is influenced by the firm's strategic importance to the Chinese government and the strength of any implicit guarantee by the government. Estimates strongly suggest that Chinese credit ratings systematically correspond to lower international ratings. EU Anti-subsidy investigations have corroborated this situation.

As far as investment funds are concerned, the Chinese government promotes since 2015 their use to '*invest in priority sectors for social and economic development'*. For example, in 2016, in the context *'Deepening the reform of SOEs'*, a private equity fund worth RMB 350 billion has been created in order to realize the restructuring of SOEs by financing mergers, acquisitions, industrial upgrades and innovation in general.

The size of China's shadow banking has increased rapidly in recent years. Its size is estimated between 30% and 50% of GDP (although this is substantially smaller than the formal banking sector).

Last but not least, the number of bankruptcy cases, which is very low for the size of the economy, points to serious issues with the enforcement of bankruptcy laws. The latter stems from a number of flaws in these laws and from their inadequate implementation in practice. In relation to that, the State plays an unduly active role in Chinese bankruptcies through various means, e.g. State-dependent Chinese courts have far-reaching discretion in the proceedings, insolvency administrators are often closely related to the local government and State guidance on insolvencies (e.g. through provisions on creditors' committees), as well as the government's overall presence in corporate affairs heavily influences the outcome of bankruptcy cases. As a result, many insolvent firms are kept afloat and firms that are subject to bankruptcy procedures end up with restructuring plans and are rarely delisted. This translates into SOEs benefiting from *de facto* governmental guarantees and provides incentives for financial market participants to lend to SOEs on relatively more favourable terms.

The overall picture emerging is one where the financial system, due to a high state presence on both borrowing and lending side, as well as the absence of normal market mechanisms such as effective and transparent bankruptcy and market exit procedures, remains highly distorted.

7. PUBLIC PROCUREMENT MARKET IN CHINA

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7.1. LEGAL FRAMEWORK

To date, China has not signed any multilateral agreement on market access for government procurement. In 2007, it applied for accession to the WTO Agreement on Government Procurement ('GPA'), but negotiations are still ongoing.

The legal framework concerning public procurement was established essentially by two pieces of legislation and their implementing rules: Government Procurement Law ('GPL') and Tendering and Bidding Law ('BL').

7.1.1. BASIC ACTS

7.1.1.1. GOVERNMENT PROCUREMENT LAW

The GPL is the basic law regarding public procurement in China. The GPL was adopted at the 28th session of the Standing Committee, during the Ninth NPC, on 29 June 2002 (effective as of 1 January 2003), and subsequently amended according to a decision of the Standing Committee on August 31, 2014.[552]

Article 2 of the GPL defines the scope of its application to '*all the government procurement activities carried out within the territory of the People's Republic of China*.'

Article 2 also refers to the use of fiscal funds '*by all levels of state authorities, institutions and social organisations to purchase goods, construction works and services that fall within the Centralised Procurement Catalogue ('CPC') or whose value exceed the respective Prescribed Procurement Threshold ('PPT')*.'

The procuring entities under the GPL are typically the government and all central and local bodies making use of fiscal funds (i.e. provinces, municipalities, hospitals, etc.). Procuring entities using non fiscal funds, such as SOEs or fiscal funds below the PPT are exempted. In addition, military procurement is not governed by the GPL but by internal military rules.

Under the GPL (Article 26), the following procedures for government procurement exist:

- *Public tender*. Used in the majority of cases, for contracts above a certain threshold. In 2014-2015,[553] the thresholds for central government procurement were RMB 1.2 million for goods and services, and RMB 2 million for construction projects. For procurement below the above-mentioned thresholds, the procuring entity may choose to apply another of the remaining procurement methods specified in the GPL.
- *Selective tendering*. Used when the goods or services to be procured are special and can only be obtained from a limited number of suppliers or when the cost of holding a public tender represents an excessive proportion of the total value of the procured items.
- *Competitive negotiation.* Mainly used when, attempting a tendering process, no supplier has submitted an offer or the offers have been deemed inadequate, or when a second tendering process has been attempted but has failed.

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[552] See *Decision of the Standing Committee of the National People's Congress on Revising the Insurance Law of the People's Republic of China and Four Other Laws*, adopted at the 10th Session of the Standing Committee of the 12th National People's Congress on August 31, 2014.
[553] See WTO Secretariat. (2016). *Trade policy review 2016: China*, 15 June 2016. p.100. https://www.wto.org/english/tratop_e/tpr_e/s342_e.pdf (accessed on 19 July 2017)

- *Request for quotation*. May be used for the procurement of goods with specifications and standards that are uniform and which are readily available on the spot at prices that fluctuate very little.
- *Single-source procurement*. Used when goods or services can be procured from only one supplier, in case of unforeseeable emergency, or in case procurement of additional items or services from the same supplier is needed and limited in amount (usually below 10% of the contract).

7.1.1.2. TENDERING AND BIDDING LAW

BL was adopted at the 11th session of the Standing Committee, during the Ninth NPC, on 30 August 1999 (effective as of 1 January 2000). It is sometimes also referred to as the Tendering Law.

Article 3 of BL provides that tendering procedures shall be carried out for

> *the following construction projects undertaken within the territory of the Peoples Republic of China, including the surveying and investigation, design, construction and construction supervision of such projects as well as the procurement of relevant major equipment and materials for such projects […]:*
>
> *(1) Large-scale infrastructure projects and public utility projects concerning public interests and public security;*
>
> *(2) Projects invested completely or partly by the government or funded through state financing;*
>
> *(3) Projects using loans and aid funds from international organizations or foreign governments.*

Consequently, the BL applies to certain tendering activities of both public and private companies, including SOEs. It is not only linked to the nature of the funds (either fiscal or private) but also to the nature of projects. It does not regulate purchasing using only private funds and not comprising activities listed above.

Under the BL (Article 10), the following bidding procedures exist:

> *Open tenders: the tenderers, in the form of tender notice, invite unspecified legal persons or other organizations to bid.*
>
> *Selective tenders: the tenderers, in the form of invitation to bid, invite specified legal persons or other organizations to bid.*

In other words, no public procurement notice is required for selective tenders.

7.1.1.3. OTHER REGULATIONS ON GOVERNMENT PROCUREMENT

Regulations in relation to procurement in a wide variety of sectors, ranging from education to environmental protection to wireless local area network products, are issued by the ministry in charge of the sector either on its own or in conjunction with the MOF.

Some of these are intended to set detailed procedures. For example, Decree No. 87 of the MOF[554] clarifies specific rules applicable to public tenders, ranging from the modalities and timing of their announcement to their evaluation and the awarding of the contracts.

Others, such as those for wireless local areas network products, are designed to promote domestic industries (see section 7.3.2). MOFCOM enacted its set of regulations in the field of electrical equipment, thus adding to the complexity of the system.

7.1.1.4. CONCESSION RULES

Public concessions are usually intended as a tool under which non-governmental investors (state-owned or private) are granted the right to invest, construct and operate a public infrastructure or utility project for a certain period of time.

There is no unified legal framework on concession contracts. However, some sectoral provisions exist. For instance, the Administrative Measures on Urban Public Utilities Concessions issued by the Ministry of Construction (the predecessor of the Ministry of Housing and Urban-Rural Development) in March 2004 and revised in 2015 ('Concession Rules') established a legal framework for urban utility-related work and service concessions, covering areas such as water, gas and heat supply, public transport, wastewater treatment and waste treatment. Under the Concession Rules, the grant of a concession is subject to a bidding process and the procedural requirements of such bidding process are set out in the Concession Rules.

Moreover, concession regimes have also been implemented in other sectors, in particular public transport and electricity generation.

7.1.2. IMPLEMENTING RULES

7.1.2.1. IMPLEMENTING REGULATIONS OF THE GPL

The Implementing Regulations of the GPL entered into force on 1 March 2015.[555] The main supplements are:

- *Expansion of scope*: Article 2 of the Implementing Regulations expands the coverage of government procurement, by noting that '*where both fiscal funds and non-fiscal funds are used for the procurement projects of State organs, public institutions and social organizations, the portions procured with fiscal funds shall be governed by the GPL and these Regulations; and, where fiscal funds cannot be separated from non-fiscal funds in procurement, the GPL and these Regulations shall apply in a uniform manner*.'

[554] On 11 July 2017, the MOF issued the Decree No. 87 revising the Measures for the Administration of Tendering and Bidding for Government Procurement of Goods and Services (Decree No. 18 of the Ministry of Finance). This Decree, in force as of 1 October 2017, specifies that its provisions are made '[…] *according to Government Procurement Law, the Government Procurement Law Implementation Regulations […]'* (Article 1).
[555] Implementing Regulations of the PRC's Law on Government Procurements, adopted on the 31st December 2014 by the 75th Executive Meeting of the State Council and shall enter into force on 1st March 2015. State Council Document number 658.

- *Transparency*: The Implementing Regulations intend to improve transparency of government procurement and e-procurement in China. Article 8 requires that all government procurement projects be published on the media designated by the finance departments at and above the provincial level. Article 10 stipulates that China will issue unified standards on government procurement electronic transaction platforms, with a purpose to promote and encourage e-procurement across China.

7.1.2.2. IMPLEMENTING REGULATIONS OF THE BL

The Implementing Regulations on the BL[556] first entered into force in February 2012 and were subsequently amended in 2017.[557] The main supplements are:

- *Local Implementing Rules:* [558] local Governments can establish their own rules, supplementing the BL and its implementing rules.
- *Web platform:* web-based platform to publish procurement notices.[559]

7.1.3. MAIN ACTORS IN PUBLIC PROCUREMENT LEGISLATION

The main actors involved in government procurement in China are:

- MOF: in charge of enforcing the GPL and of the management of the purchases of goods and services for government departments.
- NDRC: in charge drafting the BL and its implementing rules. It defines the national economic plan and approves the centrally funded large scale infrastructure projects.
- Ministry of Housing and Urban and Rural Construction: in charge of the management of general construction procurement and the implementation of the BL.
- MOFCOM: in charge of international trade and the procurement of electronic equipment.

7.2. VALUE OF THE PROCUREMENT MARKET

The European Union Chamber of Commerce in China ('EUCCC'), referring to a methodology presented by the OECD for non-OECD countries, estimates that the overall public procurement market in China, comprising the tendering by the central and local governments, other public entities and SOEs projects having public interest or using fiscal funds, should represent around 20% of China's GDP (i.e. some RMB 10.65 trillion in

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[556] Implementing Regulations on the BL of the People's Republic of China, adopted at the 183rd executive meeting of the State Council on November 30, 2011, is hereby issued, and came into force on February 1, 2012. Order of the State Council No. 613.

[557] In particular, Article 12 was amended in to read '*A bidding agency shall have in place a certain number of professionals who are capable of preparing bidding documents, organizing bid evaluation and performing other corresponding tasks.'*

[558] Cao, F., Colling, J. and Trepte, P. (2007). *China's accession to the Government Procurement agreement and opportunities for domestic reform: a study in the light of EU experience*, EU-China Trade Project and Notice on Furthering Implementation of Bidding Law by SDPC (2001), Circular on the Draft of Implementation Rules of the Bidding Law by Local Government (2001) by SDPC.

[559] See also *Temporary Provision on the Publish of Bidding Notice by SDPC Order No. 4* (2000). as amended in 2013.

2013).[560] Applying the same methodology in the year 2014, the public procurement market in China could be estimated at around RMB 12.7 trillion.[561]

Of these, some RMB 1.7 trillion (corresponding to 2.7% of the country's GDP) are attributable to government procurement under GPL, according to the information provided by the Chinese authorities to the WTO, in the framework of its accession to the GPA.[562] The remaining estimated RMB 11 trillion (or 17% of the GDP) relate to the other tendering by the central and local governments not falling under the GPL, other public entities or SOEs projects having public interest or using fiscal funds. Part of this RMB 11 trillion includes procurement expenditures under BL, although precise data on these expenditures are not available. In conclusion, it is not possible to classify the nature of procurement expenditure outside the GPL. Note that the expenditures under GPL are still quite significant in absolute terms, corresponding to more than half of the GDP of Belgium.

The table below is based on data provided by the Chinese authorities to the WTO and on estimation of the EUCCC (based on OECD methodology).

Table 7: Value of the procurement market in China

in Billion RMB	2011	2012	2013	2014
Government procurement (under GPL)	1 133	1 398	1 638	1 731
in % of the GDP	2.3%	2.6%	2.8%	2.7%
in % of the government expenditure	10%	11%	12%	11%
Other procurement expenses (including BL)	8 549	9 285	10 122	10 988
in % of the GDP	18%	17%	17%	17%
in % of the government expenditure	78%	74%	72%	72%
Total procurement expenses (20% of the GDP)	9 682	10 682	11 760	12 718

Source: WTO. (2016). *Trade policy review on China*, pp 98-102 and EUCCC. (2015). *European Business in China Position Paper 2014/2015. pp 93-102.*

[560] European Union Chamber of Commerce in China, *European Business in China Position Paper*, 2014/2015, pp.93-102. https://www.eusmecentre.org.cn/sites/default/files/European%20Business%20in%20China%20Position%20Paper%202015-2016_en.pdf Estimation are based on WTO data: https://www.wto.org/english/tratop_e/tpr_e/s342_e.pdf

[561] Computed as 20% of the GDP in 2014 (RMB 63.6 trillion, Source WTO).

[562] WTO Secretariat, Trade policy review on China, June 2016. pp 98-102. https://www.wto.org/english/tratop_e/tpr_e/s342_e.pdf

Focussing on the GPL, the expenses have significantly grown over the last years, from RMB 3.1 billion in 1998 to RMB 1.7 trillion in 2014 (an average increase of more than RMB 100 billion per year).

The large majority of government procurement under GPL (95%) is spent by the local government entities (provinces, regions, municipalities, etc.) while only 5% is spent at the central level:

Table 8: Government procurement by entities

in Billion RMB	2011	2012	2013	2014
Total procurement by the Central Government	69	79	87	83
Total procurement by local government entities	1,065	1,319	1,551	1,647
TOTAL	**1,133**	**1,398**	**1,638**	**1,731**

Source: WTO. (2016). *Trade policy review on China, pp 98-102.*

Most of the government procurement is for construction and engineering services (59%). These include buildings (including construction, reconstruction, extension, decoration, demolition and renovation), municipal construction projects and communication and transportation projects.

Goods (e.g. equipment) account for 30% of the government procurement expenses while the other services (e.g. maintenance, IT, training) account for the remaining 11%. The other services also experience the fastest expenditures growth (+118% between 2011 and 2014).

Table 9: Government procurement by nature of expenses

in Billion RMB	2011	2012	2013	2014
Goods	383	439	492	523
Construction and engineering services	661	837	993	1,014
Other services	89	121	153	193
TOTAL	**1,133**	**1,398**	**1,638**	**1,731**

Source: WTO. (2016). *Trade policy review on China, pp 98-102.*

Finally, around 84% of the value of government procurement contracts is awarded through public tendering and the figures have been growing faster than the other categories, over the 2012-2014 period (25%).

Figure 16: Government procurement by procedures

in Billion RMB	2012	2013	2014
Public Tendering	1,170.6	1,365	1,462
Selective tendering	38.6	69	46
Competitive negotiations	72.3	72	72
Request for quotations	67.9	76	64
Single-source procurement	48.4	57	52
Other	77.0	139	126
TOTAL	**1,397.8**	**1,638.1**	**1,730.5**

Source: WTO. (2016). *Trade policy review on China, pp 98-102.*

7.3. DISTORTIONS

Despite the existence of legal provisions to increase the effectiveness of public procurement, promote the construction of a clean government and allocate the contracts in a competitive way, Chinese public procurement policies are still discriminating in favour of domestic suppliers. This section demonstrates that under the current rules, discrimination in favour of national suppliers still persists and that the allocation of contracts under public procurement is not always competitive or based on market rules.

7.3.1. DISTORTIONS ASSOCIATED WITH THE GPL

In the GPL and its Implementing Regulations, the discrimination in favour of the national suppliers is explicit.

7.3.1.1. ARTICLE 10 – 'BUY CHINESE'

Article 10 of the GPL[563] stipulates:

> *The government shall procure domestic goods, construction and services, except in one of the following situations:*
>
> *(1) where the goods, construction or services needed are not available within the territory of the People's Republic of China or, though available, cannot be acquired on reasonable commercial terms;*
>
> *(2) where the items to be procured are for use abroad; and*
>
> *(3) where otherwise provided for by other laws and administrative regulations.*

This '*Buy Chinese*' policy was reinforced with the measures proposed by the State Council in 2008 to promote economic growth by expanding domestic demand (the '*stimulus package*') and by their Implementing Notice (Notice on Implementing the Decision and Deployment of Promoting Economic Growth by Expanding Domestic Demand and Further Strengthening Supervision and Administration over Engineering Construction Bidding*)* issued by the NDRC in 2009. The Implementing Notice was repealed by the NDRC in 2016.[564]

The preferential treatment of domestic suppliers is discriminatory towards foreign bidders. This results in a reduced competition in the procurement process, as less suppliers can participate. On the one hand, this could lead to a higher award price, as the number of

[563] The Government Procurement Law of the People's Republic of China adopted at the 28th Meeting of the Standing Committee of the Ninth National People's Congress on June 29, 2002 and promulgated by Order No. 68 of the President of the People's Republic of China on June 29. http://www.npc.gov.cn/englishnpc/Law/2007-12/06/content_1382108.htm (Visited 16 June 2017).

[564] NDRC Order No 31 of 1 January 2016 publishing the list of repealed acts by the NDRC. See p, 37, numbered item 845, on http://www.ndrc.gov.cn/zcfb/zcfbl/201601/t20160113_771254.html (consulted on 24 Novemeber 2017).

competing providers is restricted. On the other hand, the offered range of goods/services is limited, with possible negative impact on the delivered quality. This policy is therefore in contrast with market-based rules.

However, distortions in the Chinese government procurement market affect not only the foreign bidders, but often concern also domestic providers. As documented in a study prepared for the European Commission Directorate-General for Trade,[565] one of the goals of the central government is to favour key Chinese enterprises (the 'national champions') in the government procurement process.

A concrete example of discrimination in favour of 'national champions', and consequently against other domestic bidders, is provided in the Notice on Issuing the Opinions on Protecting and Promoting the Development of Time-honoured Famous Brands (Article 4 (5)), issued by the MOFCOM and other ministries in 2008:

> *In the government procurement and the procurement of foreign aid materials, a priority should, under the same conditions, be given to time-honoured famous brand products.* [566]

Measures like this one represent an explicit discrimination not only against foreign companies, but also against non-key domestic providers, and shows that government procurement process often operate against market-based rules, by pursuing other secondary goals.

7.3.1.2. LACK OF CLEAR DEFINITION OF 'DOMESTIC' GOOD OR COMPANY

While there is a preference for domestic products in the GPL, there is no clear definition of what is actually meant by 'domestic' good or company. A draft of the Implementing Regulations issued in 2010 for public comments defined '*domestic goods, construction and services'* as *'made within China's borders and for which domestic manufacturing costs exceed a certain percentage of the final price*'[567] and set this percentage at 50%. However, this was removed from the final version of the Implementing Regulation to avoid controversy with the consulted parties which were opposing this criterion. As a result, to date this definition is still missing.

Similarly, the Implementing Regulations do not make the distinction between local or foreign suppliers. Article 20 explicitly states that all bidders should be treated equally. However, the

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[565] Covington & Burling LLP, (2014). *Measures and Practices Restraining Foreign Investment in China,* prepared for the European Commission Directorate-General for Trade, August 10 2014, p.39.
[566] Notice on Issuing the Opinions on Protecting and Promoting the Development of Time-honoured Famous Brands (Article 4 (5).
[567] State Council of Legislative Affairs Office of State Council calls for comments on the Draft Implementation Regulations on Government Procurement Law, Legislative Affairs Office of State Council PR China, 11th January 2010.

underlying GPL still imposes a '*Buy Chinese'* clause, thus creating some doubts on the real definition of 'domestic' goods or company.

An exact definition of 'domestic' good or company is crucial to allow foreign bidders – especially Foreign Invested Enterprises ('FIEs') in China – to know whether the goods and companies they plan to include in their bids would qualify for consideration. Furthermore, the lack of an unambiguous definition leaves unnecessary room for interpretation by the procuring entities, which might result in discriminating in favour of domestic suppliers.

7.3.1.3. SUBSTANTIAL DISCRETION IN PURSUING SECONDARY POLICY GOALS

GPL and its Implementing Regulations liaise the government procurement actions to the achievement of national policy goals.

For instance, Article 9 of the GPL stipulates that '*government procurement shall be conducted in such a manner as to facilitate achievement of the goals designed by State policies for economic and social development, including but not limited to environmental protection, assistance to underdeveloped or ethnic minority areas, and promotion of the growth of small and medium-sized enterprises*.'

In addition, Article 6 of the Implementation Rules of the GPL states that:

> *The State Council Finance Department shall, in accordance with the national economic and social development policies, together with other relevant departments of the State Council, set out government procurement policies, using measures such as formulating criteria applicable to procurement needs, setting aside shares of procurements, adopting preferential price evaluation policies, conducting priority procurement, so as to achieve the objectives of energy saving, environmental protection, support to the development of less-developed regions and ethnic minority regions, promotion of the development of small and medium-sized enterprises, etc.*

The generic references made in both pieces of legislation to the achievement of national goals, without specifically naming these, leaves *de facto* a substantial discretion to the procuring entities in choosing among different candidates and offers to public tenders.

In other words, on top of the '*Buy Chinese*' policy as set out in the GPL, the Implementing Regulations introduce potentially additional distortions by allowing the procurement entities to pursue a broad (and ultimately undefined) range of policy goals and favour domestic providers. While some of these policies may pursue widely shared goals such as the protection of the environment, the provisions leave considerable discretion to the procuring

entities to also achieving other goals set by the Government (e.g. in the development plans, including FYPs, in certain sectors or provinces).[568]

For example, NDRC and SIPO (Chinese patent office) issued the Notice on the Distribution of the 12th Five Year Plan for National Intellectual Property Development.[569] Art 2(2) of this notice provides that China '*needs to develop, as soon as possible, a few research institutions that are influential internationally and a bulk of key enterprises with indigenous IPR, international brand recognition, and international competitiveness*.'[570]

7.3.2. DISTORTIONS ASSOCIATED WITH THE BL

Unlike the GPL, the BL appears '*country neutral*' since it does not explicitly mention any provision in favour of national suppliers. Nonetheless, a number of distortions are generated at the level of basic and secondary laws.

7.3.2.1. LICENCE REQUIREMENT FOR BIDDING AND PROMOTION OF 'INDIGENOUS INNOVATION' THROUGH PUBLIC PROCUREMENT

As explained above, the BL does not provide for any explicit '*Buy Chinese*' policy. However, NDRC which is the relevant body responsible for the BL implementation often requires that FIEs obtain a licence in order to participate in bidding procedures in China.

This is in line with a broad government goal of promoting 'indigenous innovation.'[571] For this, central and local governments stipulate domestic innovation requirements in public procurement tenders.[572]

A study conducted for the European Commission Directorate-General for Trade on measures restraining foreign investments in China[573] screened some 137 328 measures from 27 sampled government agencies that can promulgate laws and 125 910 measures from five sampled provincial governments. This study could identify at least 54 measures (1 at central level and 53 at local level) relating to government procurement and containing at least one restraint that favour domestic investors or investments over foreign investors or investments.

An example at the central level was included in the Management Measures for Indigenous Innovation Product Accreditation ('Measures'), issued by the State Council on 31 December

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[568] The development goals developed in development plans and FYPs are extensively discussed in the dedicated chapter of this report.
[569] Notice on the Distribution of the 12th FYP for National Intellectual Property Development. (SIPO, NDRC et. al., 2011).
[570] Covington & Burling LLP, (2014). *Measures and Practices Restraining Foreign Investment in China,* prepared for the European Commission Directorate-General for Trade, August 10 2014, p.35.
[571] National Medium- and Long-Term Program for Science and Technology Development (2006-2020), issued by the State Council on December 26, 2005.
[572] Covington & Burling LLP, (2014). *Measures and Practices Restraining Foreign Investment in China,* prepared for the European Commission Directorate-General for Trade, August 10 2014, p.37.
[573] Ibid., Tables 5 and 7.

2006.[574] The Measures required various government departments to compile accreditation lists. Only IP right holders that were registered for the first time in China were permitted to be included in the list of producers allowed to participate in public procurement of innovative products. The first such list was issued in 2009 and the Measures were repealed in 2011.[575]

An example at the local level is included in the Regulations of Tianjin Municipality on Patent Promotion Protection.[576] Its Article 23 states that for '*government procurement and other procurement where financial funds are used, products with indigenous patents shall be considered first. When indigenous innovation products with patent rights enter the market* […] *the government shall begin to procure or order these products.*'

The licensing requirements or more generally the promotion of '*indigenous innovation*' in tenders are present is different sectors.

In the rail market, with the Notice of General Office of the State Council on Forwarding the Opinions of National Planning Commission on Implementation of Localization of Urban Rail Traffic Equipment[577] the central government intended to promote local rail traffic equipment:

> *In order to promote smooth implementation of localization of urban rail traffic equipment, the state will organize experts to assess the localisation of vehicles and mechanical and electric equipment in urban rail traffic projects, and may offer appropriate incentive policies to those projects which satisfy the aim of localization as well as guide provincial governments to procure domestic equipment.*

According to the Association of the European Rail Industry ('UNIFE'),[578] the accessibility rate of foreign investors to the Chinese rail market dramatically fell from 65% in 2009-2011 to 20% in 2013-2015. The NDRC requirement to obtain a licence can only be achieved by constituting a Joint Venture ('JV') with a Chinese partner. Although there are no formal rules at the national level, the concerned parties often claim that tenders are only open to local companies or to JVs where the Chinese partner has no less than 50% of the JV's shares.[579]

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[574] European Commission, Overview of potentially trade restrictive measures identified between 2008 and end-2015, May 2016, o.59.
[575] Notice on the Cessation of the Implementation of the *Management Measures for Indigenous Innovation Product Accreditation'* July 2011.
[576] Regulations of Tianjin Municipality on Patent Promotion & Protection, Article 23 (Standing Committee of Tianjin People's Congress, No. 26, 2011).
[577] Notice of General Office of the State Council on Forwarding the Opinions of National Planning Commission on Implementation of Localization of Urban Rail Traffic Equipment (General Office of the State Council) (Feb 1999). This is almost 20 years ago.
[578] See UNIFE, *Annual Report 2016* (http://www.unife.org/component/attachments/attachments.html?id=772 , consulted on 23 November 2017).
[579] See UNIFE, *Position Paper Accessibility of China's Rail Market for the European Rail Supply Industry*, July 2016, p.7

This practice in the rail market and in other industries appears to be persisting, despite the State Council circular number 5 on Promotion of the Opening-up and Active Use of Foreign Investments, introduced in January 2017. The circular states:

> *It is vital to deepen government procurement reform, adhere to the principles of openness, transparency and fair competition, treat the products produced by foreign-invested enterprises in Mainland China equally pursuant to laws and regulations, and facilitate Chinese-funded and foreign-invested enterprises to participate in bidding and bid submission for government procurement in a fair manner.*

Finally, several tender invitations provide for penalisation or exclusion of the consortia. For example, in 2014 the China Railway Group launched a tender to supply some 232 high-speed trains where consortia were excluded from the bidding.[580]

EUCCC points out that examples like the ones described in this chapter are recurrent in sectors such as energy, construction, engineering, etc. Therefore, these represent a *de-facto* extension of the '*Buy Chinese*' policy to a substantial part of the tenders falling under the BL.[581]

7.3.2.2. LACK OF REMEDIES SYSTEM

GPL Rules introduced an articulate bid challenge and complaint system.[582] This system guarantees the bidders three grades of complaints to ensure their right of defence (i.e. to the procuring entity, to the department for supervision of government procurement, to the People's Court). It sets forth a streamlined procedure and criteria that complainants and complaints have to meet in order to be eligible. The Implementing Regulations to the GPL further develop the framework by streamlining the procedures relating to the available remedies.[583]

By contrast, the BL remains quite general on the complaint system. The only reference to complaints is made under the supplementary provisions in Article 65: *'A bidder or any other interested person has the right to raise his objections to the tenderer or to file a complaint with the relevant administrative supervision department if he believes that the bidding and tendering activities do not comply with the relevant provisions of this Law.'*

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[580] Barrow, K. (2014). China issues tenders for 232 high-speed trains. International Railway Journal http://www.railjournal.com/index.php/high-speed/china-issues-tenders-for-232-high-speed-trains.html (accessed on 29 August 2017).
[581] European Union Chamber of Commerce in China, *European Business in China Position Paper*, 2014/2015, p. 106
[582] See GPL Chapter VI (articles 51 to 58).
[583] See Implementation Rules of the GPL (Chapter VI, Articles 52 to 58).

The BL does not provide procedures or remedies for loss or damage to the aggrieved tenderer, but subsequent Implementing Regulations [584] clarified that the ultimate body to handle complaints on bidding activities is the NDRC, which will not accept the case if other regulatory authorities have already accepted the complaint.

Therefore, under the BL, complainants cannot claim for compensation. The rationale behind the lack of a remedy system in the BL was that the aggrieved tenderers could refer to the existing administrative rules, at each level of the public administration. However, unlike the GPL, the procurement under BL covers a wide array of procuring entities (SOEs, Ministries, local or central authorities). Hence the processes and the supervision authorities can differ. This means that a company that wants to lodge a complaint shall refer each time to a different body or complaint process.

This complexity could have a dissuasive effect on suppliers, especially foreigners, in bidding under the BL.

7.3.3. REGULATORY CONFLICTS BETWEEN GPL AND BL

There is a continuous tension between the two basic acts. The EU-China Trade Project carried out a comprehensive study on the conflicts between GPL and BL. Although this study was delivered in 2008 and in 2014 the Implementation Rules of the GPL providing some clarifications were issued, there are still some areas of conflicts between the two basic acts.

The GPL (Article 2)[585] applies to Government procurement activities conducted with fiscal funds by all public administration levels, for goods, construction and services included in the CPC and for values exceeding a PPT.

In contrast, the BL (Article 3)[586] applies to tendering activities of both fiscal and private entities, including SOEs, in large-scale infrastructure projects and public utility projects concerning public interests and public security; projects invested completely or partly by the government or funded through state financing; and projects using loans and aid funds from international organizations or foreign governments.

The two sets of legislation overlap when the construction projects falling under the BL are conducted with fiscal funds.

The GPL (Article 4) tried to address this clash by providing that '*the Tendering Law* [the BL] *shall apply to tendering proceedings in government procurement of construction works*.' In addition, the Implementing Rules of GPL further clarify that '*when an engineering work*

[584] *Inter alia*, the Measure on Handling the Complaints of Bidding for Construction Projects by NDRC, Ministry of Construction, Ministry of Railway, Ministry of Communications, Ministry of Information Industry, Ministry of Water Resource, and General Administration of Civil Aviation, issued and effective on 1 Aug, 2004.
[585] See explanations in para. 7.1.1.1.
[586] See explanations in para. 7.1.1.2.

subject to government procurement and the goods and services related to the construction thereof are procured by way of bidding, the BL applies.'

But the current practice still experiences the application of GPL when fiscal funds are used. A tangible and explicit evidence of this risk is contained in Art. 22 of the Notice on Implementing Several Supporting Policies for the Outline of the National Medium - *and Long-Term Program for Science and Technology Development (2006-2020)*[587] issued by the State Council in 2006:

> *For major national construction projects and other major equipment and products procurement projects involving fiscal funds, the relevant authorities shall list a commitment to procuring indigenous innovation projects as one of the conditions in their projects application and clearly indicate the specific requirements for procuring indigenous innovation projects. For key projects with government investment from the state or local level, the ratio of procuring domestic equipment shall be no less than the 60% of the total value. The finance department shall not release the funds if the requirements of procuring indigenous innovation projects are not satisfied.*

These are provisions clearly echoing the '*Buy Chinese*' policy of the GPL, although these apply to projects (i.e. '*construction projects')* falling under the scope of the BL.

The potential inconsistency in the application of one or the other legislation generates uncertainty for both procuring entities and suppliers. In particular, foreign providers face a concrete risk of being discriminated if the procuring entities opt for the application of the GPL (including the '*Buy Chinese'* policy), rather than the BL.[588]

7.4. FACTUAL CONSEQUENCES AND EXAMPLES

This section outlines some real examples of distortions observed in certain sectors.

- *Medical Equipment*. According to the European Commission monitoring of potential trade barriers, [589] in the field of Medical equipment, the National Health and Planning Commission launched an initiative urging hospitals to purchase medical devices from 'national' manufacturers, not including products manufactured in China by FIEs. The first

[587] Notice on Implementing Several Supporting Policies for the Outline of the National Medium- and Long-Term Program for Science and Technology Development (2006-2020), Article 22 (State Council, No. 6, 2006).
[588] See European Union Chamber of Commerce in China, European Business in China Position Paper, 2015/2016, pp.105-110. https://www.eusmecentre.org.cn/sites/default/files/European%20Business%20in%20China%20Position%20Paper%202015-2016_en.pdf (accessed on 29 August 2017).
[589] European Commission Staff Working Document, Analysis of new potentially trade restrictive measures in the period 1 July 2014-31 December 2015, 2016. http://trade.ec.europa.eu/doclib/docs/2016/june/tradoc_154664.pdf and European Commission, Overview of potentially trade restrictive measures identified between 2008 and end-2015, May 2016. http://trade.ec.europa.eu/doclib/docs/2016/may/tradoc_154568.pdf

batch catalogue was published in December 2014. It did not contain any explicit additional restriction of market access of imported medical devices or products manufactured in China by FIEs. However, the initiative remains valid and there are examples of the invitation being followed up in practice in a general atmosphere favouring the purchasing of 'national' medical devices. For example, EUCCC reported[590] in June 2014 that the Shanghai Municipal Commission of Health and Family Planning issued the Notice on Further Strengthening the – Management of Large Medical Equipment Configuration in Class B of the Municipality,[591] requiring in Chapter 3 that assuming that basic clinical needs can be met, '*medical institutions at the district level shall in principle choose domestic-made, large equipment when purchasing a second set of such equipment*.'

- *Air Tickets*: The European industry pointed out the existence of an explicit barrier against FIEs bidding for contracts for supplying tickets to government personnel travelling on business.[592] On 14th April 2014, the MOF and Civil Aviation Administration of China issued the Notice on Strengthening Official Air-ticket Purchase [593] which explicitly stipulates the '*principle of development of national airlines'* (Article 1). This translates in the obligation to give precedence to domestic airliners when purchasing tickets for business purposes to any category of staff in all levels of public institutions in China, or when purchasing commercial tickets using fiscal funds. Moreover, Article 3 obliges the officials which are not in a position to choose a national carrier, to submit an approval form to '*take non-domestic airline flights and change the transit*' to the relevant foreign affairs and financial departments.

- *Innovation products.* [594] The introduction of the Indigenous Innovation Product Accreditation List on 17 November 2009, made more stringent the requirements to be inserted in the accreditation list of innovative products (i.e. Intellectual Property Rights ('IPR') requirements, short registration timeframe, etc.).

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[590] European Union Chamber of Commerce in China, *European Business in China Position Paper*, 2015/2016, pp.210. https://www.eusmecentre.org.cn/sites/default/files/European%20Business%20in%20China%20Position%20Paper%202015-2016_en.pdf

[591] Notice on Further Strengthening the Management of Large Medical Equipment Configuration in Class B of the Municipality, Maritime Health and Family Planning Commission, June 10, 2014. http://www.wsjsw.gov.cn/wsj/n429/n432/n1487/n1504/u1ai134123.html

[592] See European Union Chamber of Commerce in China, *European Business in China Position Paper*, 2014/2015, pp.97. https://www.eusmecentre.org.cn/sites/default/files/European%20Business%20in%20China%20Position%20Paper%202015-2016_en.pdf

[593] MOF, *Notice on Strengthening the Relevant Matters Concerning the Purchase and Management of Official Air Tickets*, 2014. Document number 33. http://gks.mof.gov.cn/redianzhuanti/zhengfucaigouguanli/201404/t20140422_1070183.html (visited on 15 June 2017).

[594] European Commission, Overview of potentially trade restrictive measures identified between 2008 and end-2015, May 2016. http://trade.ec.europa.eu/doclib/docs/2016/may/tradoc_154568.pdf

- *Wind power equipment.*[595] In 2006, the Provisional Measures for the Accreditation of National Indigenous Innovation stated that products made with Chinese intellectual property could qualify for priority in government procurement. While the Chinese government officially ended this practice in December 2011, the European Commission reports that the policy change did not apply to purchases made by China's SOEs, which controlled a significant part of the market.[596]

- *Automotive.*[597] MIIT released a preliminary list for official government automotive fleet purchases on 24 February 2012. This list only includes local Chinese car brands.

- *Postal and express delivery industry.*[598] The State Postal Bureau issued the *Specifications for Allocating Safety Production Facilities in Postal Industry*, which tightened the compulsory requirements for security measures. As a result, it limited strongly foreign investments in the domestic postal delivery service.

- *Pharmaceuticals.*[599] Since 1998 the NDRC has mandated 28 rounds of price reductions of reimbursement for drugs estimated to have impacted 1 318 types of drugs by an average of 21%. As a practical matter, in accordance with the newly-listed *National Reimbursement Drug List*, it is often the case that local generic drugs may be fully reimbursed while brand drugs may be only partially reimbursed.

- *Chemical manufacturing*.[600] NRDC issued in 2005 the Urgent Notice Regarding the Orderly and Healthy Development of the Oil Refining and Ethylene Industry.[601] Article 4 states: '*Large petrochemical installations have been listed as a focus area of the State's revitalization of the equipment manufacturing industry. We must actively adopt technologies and domestic equipment that are developed indigenously or that are re-innovated after being imported, digested, and absorbed, strengthening the capability of indigenous innovation and system integration.*'

7.5. CHAPTER SUMMARY

Approximately one-fifth of China's GDP is generated by public procurement. In 2014 that segment of the economy was estimated to be RMB 12.7 trillion. These vast sums are subject

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[595] Ibid.
[596] Ibid., p. 60.
[597] European Commission, Overview of potentially trade restrictive measures identified between 2008 and end-2015, May 2016. http://trade.ec.europa.eu/doclib/docs/2016/may/tradoc_154568.pdf
[598] European Commission Staff Working Document, Analysis of new potentially trade restrictive measures in the period 1 July 2014-31 December 2015, 2016. http://trade.ec.europa.eu/doclib/docs/2016/june/tradoc_154664.pdf
[599] http://www.ecco-offset.eu/wp-content/uploads/Forum-5.1-Letter-of-China-J-Paul-Tchang.pdf
[600] Covington & Burling LLP, (2014). *Measures and Practices Restraining Foreign Investment in China*, prepared for the European Commission Directorate-General for Trade, August 10 2014.
[601] Urgent Notice Regarding the Orderly and Healthy Development of the Oil Refining and Ethylene Industry, (NDRC and MOFCOM, No. 2617, 2005).

to two pieces of legislation, the GPL and the BL and their respective implementing rules. The former (GPL), effective since 2003, applies to government procurement for goods, construction and services conducted with fiscal funds at all administrative levels above certain thresholds. The latter (BL), effective since 2000, governs procurement activities of both fiscal and private entities (including SOE's) relating to large infrastructure and public utility projects. These projects can be financed totally or, in part, by the government, state financing, loans and aid funds from international organisations or foreign governments.

The existence of legislation and implementing guidelines, while designed to improve the effectiveness of public procurement in China, hides the fact that the allocation of contracts under these rules is not always necessarily open, competitive or based on market rules.

Preferential treatment of domestic over foreign enterprises is enshrined in the GPL where the *'buy Chinese'* provisions are explicitly set out. Ensuing distortions, as a result of limiting the competitive field, can manifest themselves through higher award prices or a limited range of goods and services on offer. These restrictive practices can be further compounded by discrimination in favour of 'national champions' as expressed in a 2008 notice of the MOFCOM regarding the protection and promotion of famous brands. While the BL does not explicitly require *'buy Chinese'*, certain practices including licencing requirements, preferences for holders of indigenous patents as well as exclusions of consortia, in fact skew the process in favour of Chinese enterprises. Such practices are prevalent in sectors including energy, construction and engineering.

The pursuit of secondary policy goals through the public procurement process further undermines market based principles in the area. The legislation specifically provides that public procurement shall be conducted in order to facilitate the achievement of goals designed by state policies. Given the undefined nature of these goals, there is broad scope for interpretation by the decision making bodies in justifying the allocation of contracts, thus overriding market driven decisions.

Ambiguities regarding the definition of domestic enterprises (e.g. whether they include FIEs), a lack of clear or effective remedial systems against challenges and complaints, overlaps and opaque provisions existing in both sets of the relevant governing legislation all serve as further deterrents to foreign suppliers bidding for public procurement contracts in China.

Given the value of procurement contracts in China, representing as they do 20% of China's GDP, the absence of clear competitive market based rules has a significant distortive effect.

8. INVESTMENT RESTRICTIONS FOR CHINESE AND FOREIGN COMPANIES

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8.1. INTRODUCTION

Since 1978, when China adopted its broad 'reform and opening up policy' (See Section 2), China's leadership has repeatedly expressed its intentions to liberalize market access for domestic and foreign investment, replacing the highly centralized investment management system associated with China's former planned economy with a more market-oriented

investment regime. However, even as of today, there are significant barriers in place for foreign and domestic private investment, resulting from a desire on the part of the Chinese leadership to actively manage the country's industrial and economic development.[602]

The State plays a pivotal role in determining the destination and magnitude not only of state but also of private investment[603] in China (and even, for both state-owned and private domestic investors, outside of China), guiding economic decision-making in line with a complex web of industrial policies – industrial policies that are national and local, cross-sector and industry-specific, and medium- and long-term and short term. The government's toolkit for supporting industrial policy goals includes laws, regulations, and an investment approval process that apply varying treatment and levels of scrutiny depending on the nature of the investor and the investment being contemplated. Through incentives, restrictions, and prohibitions related to investment, the Chinese government maintains considerable control over the country's economy.

The main government agencies involved in the regulation of private investment in China are:

- **NDRC** (together with local DRCs): Oversees China's economic development and industrial policy framework and conducts project approvals for certain investment projects;
- **MOFCOM** (together with local commerce departments): Lead agency regulating foreign investment (including overseeing anti-trust reviews);
- **SAIC** (together with local AICs): Responsible for administrative registration of enterprises; and
- **Various Industry Regulators:** Regulate and grant licenses for activities in specific industries.

This chapter first takes a high-level look at China's system of laws, regulations, and policies that lay out and effectuate the country's industrial and economic policies and have an impact on investment decisions, both at a high level and, often, in very detailed form. This is followed by a description of the approval process for private investment, which serves as a vehicle for the government to micromanage the country's economy in line with such industrial and economic development policies – particularly in sectors of interest.

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[602] See also - European Commission Staff Working Document, Analysis of new potentially trade restrictive measures in the period 1 July 2014-31 December 2015, 2016. http://trade.ec.europa.eu/doclib/docs/2016/june/tradoc_154664.pdf and European Commission, Overview of potentially trade restrictive measures identified between 2008 and end-2015, May 2016. http://trade.ec.europa.eu/doclib/docs/2016/may/tradoc_154568.pdf

[603] The use of the term 'private investment' in this report primarily refers to investments made by private domestic investors and private foreign investors. Depending on the circumstances, investments by state-owned enterprises may or may not be subject to the same written rules or rules as they apply in practice.

8.2. INDUSTRIAL POLICY PRESCRIPTIONS IN LAWS, REGULATIONS, AND POLICY DOCUMENTS THAT IMPACT INVESTMENT DECISIONS

Chinese industrial policy documents take a wide range of forms, as noted in Chapter 4 (see, in particular, Section 4.2). Amidst that wide range of goals contained in Chinese industrial and economic policies features the goal of the domestic economy benefiting from foreign investment while not allowing it to undermine domestic industry. These economic policy goals are expressed through a range of policy documents, and then implemented through laws, regulations, and administrative approval processes, including the approval process for private investment.

8.2.1. GOAL: MAINTAINING CONTROL OVER KEY INDUSTRY SECTORS

The Chinese state maintains control over key or otherwise sensitive industry sectors through the use of a range of policy tools. It carefully regulates any and all private investment activity in such sectors – leveraging. for instance, additional approval authority (as provided in the Project Approval Catalogue, discussed in Section 8.3.2.1 below) – and creates space for SOEs in these sectors through an array of restrictions, prohibitions, and incentives that operate both pre-establishment and post-establishment.

8.2.1.1. MARKET ACCESS PREFERENTIAL TREATMENT FOR SOES

According to a report commissioned by the European Commission Directorate-General for Trade, many measures granting preferential treatment to SOEs have their effect prior to the establishment of an enterprise, i.e. by prohibiting or restricting the ability of non-SOEs to investment in particular sectors.[604] Discussed in greater detail in Section 8.3.2.1 below, the Project Approval Catalogue, a detailed industrial policy document with binding effect through the investment approval process, lists industry sectors that require project approvals from NDRC or other designated central or local government agencies.[605] Industry sectors listed in the Project Approval Catalogue tend to be key industry sectors in which the state-owned sector plays a prominent role. Further, laws and regulations prohibiting or restricting the activities of private investors (both domestic and foreign) or otherwise benefiting SOEs can be found in cross-industry laws and regulations,[606] as well as those focused on specific industries such as telecommunications, national defence, postal services, and distribution.[607]

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[604] Covington & Burling, (2015). *Assessing "National Treatment" as a Basis for Securing Market Access nder a Comprehensive Agreement on Investment with the PRC*, July 23, 2015, p. 63-66.

[605] Designated approval authorities for different types of projects include the State Council, industry-specific regulators, and the local counterparts of these government organs.

[606] *See, e.g.* the *Anti-Monopoly Law* discussed below, and the *Foreign Trade Law* (中华人民共和国对外贸易法, Standing Committee of the National People's Congress, 2004).

[607] *See, e.g.* 关于公布 2014 年出口许可证管理货物目录的公告 (Announcement on the Publication of the Catalogue of Goods under Export License Administration for 2014), Ministry of Commerce & General Administration of Customs;广东省人民政府关于贯彻落实国务院部署加快培育和发展战略性新兴产业的意见 (Opinion of Guangdong Provincial Government on Implementation of Rules of State Council on Accelerating

AML, for example, singles out SOEs for special treatment. Although it does not explicitly exempt SOEs from the operation of the AML (see also section 5.5.1), Article 7 of the law suggests that SOEs are to be placed in a privileged position, stating that when these companies are operating in certain important or sensitive sectors (e.g. important for the national economy or national security), the State shall offer protection and 'facilitate technological advancement' when supervising and regulating their businesses:

> *With respect to the industries which are under the control of the State-owned economic sector and have a bearing on the lifeline of the national economy or national security and the industries which exercise monopoly over the production and sale of certain commodities according to law, the State shall protect the lawful business operations of undertakings in these industries, and shall, in accordance with law, supervise and regulate their business operations and the prices of the commodities and services provided by them, in order to protect the consumers' interests and facilitate technological advance.*[608]

8.2.1.2. POST-ESTABLISHMENT PREFERENTIAL TREATMENT FOR SOES

Even after an enterprise has been established, it may find itself in competition with SOE that are provided with various forms of preferential treatment.[609] Expectations regarding post-establishment treatment can also impact investment decisions at the pre-establishment stage.

Post-establishment benefits to SOEs from the government can assume a number of different forms, e.g.:[610]

a) Free land allocation;[611]
b) Preferential financing through the banking system, facilitating greater access and/or below-market rates for credit;[612]
c) Direct financial support;[613] and

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the Cultivation and Development of Strategic Emerging Industries), People's Government of Guangdong Province, 2011.

[608] AML, Article 7.

[609] Covington & Burling. (2015). *Assessing "National Treatment" as a Basis for Securing Market Access Under a Comprehensive Agreement on Investment with the PRC*, July 23, 2015, p. 67-69.

[610] See full discussion in ibid.

[611] *See, e.g,* 国土资源部关于加强土地资产管理促进国有企业改革和发展的若干意见 (Several Opinions of the Ministry of Land and Resources on Further Control over Land Assets and Promotion of the Reform and Development of State-owned Enterprises), Art. 2 (MLR, effective Nov. 25, 1999); 中共上海市委、上海市人民政府关于进一步深化上海国资改革促进企业发展的意 见 (Opinions on Further Deepening Shanghai SOE Reforms to Promote Enterprises Development), Art. 19 (CPC Shanghai Municipal Committee and Shanghai Municipal People's Government, effective Dec. 18, 2013).

[612] *See, e.g.* 中国人民银行、国家经贸委关于支持国有亏损工业企业有销路、有效益产品生产的通知 [Notice jointly Issued by People's Bank of China and State Economic & Trade Commission on Supporting Production of Marketable and Profitable Products of State-owned Industrial Enterprises in Loss] (PBOC, MOFCOM, effective Sep. 11, 1997).

[613] See, e.g. 中央国有资本经营预算支出管理暂行办法 (Interim Measures for the Management of Central State-owned Capital Operating Budgetary Expenditure) MOF, effective 13 March 2017

d) Indirect support via government procurement.[614]

These topics are discussed in other chapters in this report (see Chapters 6, 7, 9, and 11).

8.2.2. GOAL: ADVANCING THE CAPABILITIES OF DOMESTIC INDUSTRY

Beyond seeking to shore up the strength of the SOE sector in key industries, a central goal of Chinese economic policy is to advance the capabilities of domestic industries overall, including those of private domestic industry. In recent years, two key themes that have risen to prominence in this regard are: (1) fostering indigenous innovation capabilities, and (2) promoting domestic champion companies.[615] Advancing domestic industry also involves trimming or restructuring industries that have outlived or outgrown their purpose. Both of these goals are furthered by China's approach to investment scrutiny, as will be described in more detail below.

8.2.2.1. SEEKING TO FOSTER INDIGENOUS INNOVATION

A key focus of recent industrial policies, including the 13th FYP, has been to improve the Chinese economy's capacity for innovation. This theme can be seen manifested throughout Chinese industry policymaking, perhaps most notably in policies relating to the information technology industry.

One of the most well-known of such plans, the National Medium- and Long-Term Plan for Science and Technology Development (2006-2020) ('S&T MLP'), proposed a series of measures to encourage 'indigenous innovation' listing 10 'important fields' and 62 'priority topics' within them for advancing the country's scientific and technological capabilities.[616] The following excerpt, from Part II of the Plan ('Guiding Principles, Development Goals, and General Deployment'), illustrates the vision of the State concerning the promotion of indigenous innovation, and calls for a national strategy to implement it:

> *The guiding principles for our Science and Technology undertakings over the next 15 years are: indigenous innovation, leapfrogging in priority fields, enabling development, and leading the future. […] This calls for placing the strengthening of indigenous innovation capability at the core of Science and Technology undertakings. The Party and government have long advocated and paid close attention to indigenous innovation. To press ahead with the modernization drive under conditions of opening to the outside world, we must earnestly study and draw on all the fine achievements of human civilization. During the past two decades or so since we began to pursue the policy of reforms and opening to the*

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[614] Covington & Burling. (2015). *Assessing "National Treatment" as a Basis for Securing Market Access Under a Comprehensive Agreement on Investment with the PRC*, July 23, 2015, p. 67-69.
[615] *Measures and Practices Restraining Foreign Investment in China, prepared for the European Commission Directorate-General for Trade*, August 10 2014. pp. 36-40.
[616] Outline of the National Medium- and Long-Term Plan for Science and Technology Development (2006-2020), (State Council, effective Dec. 26, 2005).

outside world, our country has imported a huge amount of technologies and equipment, which played an important role in raising the overall technological level of our industries and promoting the country's economic development. However, one should be clearly aware that importation of technology without emphasizing assimilation, absorption, and re-innovation is bound to weaken the nation's indigenous R&D capability, which in turn widens the gap with world advanced levels. Facts have proved that, in areas critical to the national economy and security, core technologies cannot be purchased. If our country wants to take the initiative in the fierce international competition, it has to enhance its indigenous innovation capability, master core technologies in some critical areas, own proprietary intellectual property rights, and build a number of internationally competitive enterprises. In a word, the improvement of indigenous innovation capability must be made a national strategy that is implemented in all sectors, industries, and regions so as to drastically enhance the nation's competitiveness.[617]

This kind of language is not only found in policy. The S&T MLP's states that '*all policies and measures must be conductive to enhancing the capabilities of indigenous innovation*.' More specifically, the S&T Plan states that a key task for policymakers is to be '*guiding enterprises to increase investment in research and development through [the implementation of preferential] fiscal, financial, and other policies, and the promotion of enterprises, especially large enterprises, to establish research and development institutions*.'

Another excerpt from the S&T MLP exemplifies the level of detail found in state policy planning:

Through efforts over the next 15 years, the nation will meet the following objectives in some major scientific and technological areas: 1) mastering core technologies in equipment manufacturing and information industry that are critical to the nation's competitiveness, and bringing the technological capability of manufacturing and information industries to the world advanced levels; 2) making the nation a world leader in overall agricultural S&T capability, raising the comprehensive capacity of China's agricultural production, and ensuring the nation's food safety.; 3) achieving technological breakthroughs in energy development, energy conservation, and clean energy, and advocating optimized energy structures, with unit energy consumption of major industrial products reaching or approaching world advanced levels; 4) establishing technological development models featured with circular economy in major sectors and municipalities, and providing Science and Technology support for building a resource saving and environment friendly society; 5) noticeably enhancing the

[617] Outline of the National Medium- and Long-Term Plan for Science and Technology Development (2006-2020) (State Council, effective Dec. 26, 2005).

level of major diseases prevention and control, curbing the spread of major diseases, including HIV/AIDS, hepatitis and other major diseases, striving for breakthroughs in new drugs and key medical equipment, and developing a technological capability for industrialization; 6) in defence science and technology, basically meeting the needs in developing modern arms and associated information technology, and providing S&T support for safeguarding national security; 7) establishing a world-calibre contingent of scientists and research teams, attaining high-impact innovative achievements in the mainstream of science development, bringing the technological level in such frontier areas as information, biology, materials, and space to world advanced levels; and 8) establishing a number of world-class research institutes and universities, and world-competitive industrial R&D centres so that a fairly comprehensive national innovation system of Chinese characteristics can take shape.

More recently, the *13th FYP for Strategic Emerging Industries* ('SEI 13th FYP'), which accompanies the main 13th FYP, the State Council made the following request:

> *Focus on making breakthroughs in core key technologies, further improve indigenous innovation capabilities, [and] comprehensively enhance the added value and international competitiveness of [Chinese] products and services*.[618]

In particular, the SEI 13th FYP emphasizes indigenous innovation in aviation, bio-agriculture, information technology, satellite technology and its applications, culture and communications, aerospace, and genetic coding.[619]

8.2.2.2. SEEKING TO PROMOTE DOMESTIC CHAMPION COMPANIES

The SEI 13th FYP also demonstrates the key goal of promoting domestic champion companies – large, powerful Chinese companies that dominate markets domestically and globally – with language that is representative of how this goal is manifested in various Chinese legal and policy measures. For a series of industry sectors, the SEI 13th FYP calls for '*vigorously improving product quality [and] fostering a batch of PRC brands having international influence*.'[620] It goes on to set goals for 2020: '*develop a batch of pacesetter enterprises with strong abilities for originality, international influence, and good brand reputation; and small and medium sized enterprises with vitality and bravery to explore and continue to emerge'*, and for 2030: '*China to become a worldwide important manufacturing centre and innovation centre for strategic emerging industries, and there to form a batch of leading innovative enterprises with global influence and a dominant position'*.[621]

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[618] SEI 13th FYP, Section I-3.
[619] Ibid., Section II-VII.
[620] Ibid., Section II-4.
[621] Ibid., Section I-4.

This kind of language in high-level policy documents also makes its way into legal and regulatory measures issued by Chinese government agencies. For instance, in a 2008 notice, MOFCOM requires government agencies to '[*e]stablish a promotion system and give an impetus to time-honoured famous brands to enhance their competitive capabilities in the market*.'[622] It goes on:

> *(4) To support the innovation and development of time-honoured famous brands by using fiscal funds. All qualified companies may, under relevant provisions, apply for policy support such as the pertinent brand development funds, the funds exclusive for promoting the development of small and midsize enterprises and funds for small and midsize enterprises to explore the international market.*
>
> *(5) To support the time-honoured famous brands to explore markets. In the government procurement and the procurement of foreign aid materials, a priority should, under the same conditions, be given to time-honoured famous brand products. In the allocation of import and export quotas and the licensing of franchise businesses, time-honoured famous brand products and enterprises should be given a priority within the licensing scope as provided for by laws and regulations.*[623]

8.2.2.3. PROMOTING INDUSTRIAL RESTRUCTURING

In addition to bolstering domestic industry, industrial policies are also used to restructure existing industry, sometimes cutting away at industries that have outlived or outgrown their purpose. NDRC's Catalogue for Guiding Industrial Restructuring ('Restructuring Catalogue', see Section 4.2.11 for more details concerning the Catalogue and Decision No 40) [624].

The contents of the Restructuring Catalogue are not simple lists. They go into considerable detail in order to make sure that government officials implementing the policies it outlines have clear instructions on how to proceed. For instance, one sub-section of the restricted list covers petrochemicals. An excerpt from that sub-section reads as follows:

> *1. new construction of atmospheric and vacuum distillation units with an annual output of less than 10 million tonnes, catalytic cracking units with an annual output of less than 1.5 million tonnes, continuous reforming units (including aromatics extraction) with an annual output of less than 1 million tonnes, and hydrocracking units with an annual output of less than 1.5 million tonnes.*
>
> *2. new construction of production units (excluding comprehensive utilization) of ethylene by naphtha cracking with an annual output of less than 800 000 tonnes,*

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[622] Certain Opinions on Protecting and Promoting the Development of Time-Honored Famous Brands, Art. 4 (4) (5) (MOFCOM et. al., No. 104, 2008) (Mar 2008).
[623] Ibid.
[624] Catalogue for Guiding Industrial Restructuring (Revised in 2013), Order No. 21 of the National Development and Reform Commission.

acrylonitrile with an annual output of less than 130 000 tonnes, purified terephthalic acid with an annual output of less than 1 million tonnes, ethylene with an annual output of less than 200 000 tonnes, styrene (excluding ethylbenzene by dry gas process) with an annual output of less than 200 000 tonnes, caprolactam or ethylene acetic acid with an annual output of less than 100 000 tonnes, acetic acid by oxo systhesis or methanol by natural gas with an annual output of less than 300 000 tonnes, and coal methanol with an annual output of less than 1 million tonnes; production units of acrylic by acetone cyanohydrin process, acetone/butanol by food process, epichlorohydrin by chorohydrin process, and epichlorohydrin by saponification process; and production units of saponin (including hydrolyzate but excluding comprehensive utilization)with an annual output of less than 300 tonnes.

3. new construction of production units of polypropylene with an annual output of less than 70 000 tonnes (by continuous process and batch process), polyethylene or polyvinyl chloride by acetylene process with an annual output of less than 200 000 tonnes, polyvinyl chloride by ethylene oxychlorination process with an initial scale of less than 300 000 tonnes, polystyrene with an annual output of less than 100 000 tonnes, acrylonitrile/butadiene/styrenecopolymer (ABS, excluding noumenon continuous process) with an annual output of less than 200,000 tonnes, and ordinary synthetic latex-carboxy butadiene-styrene rubber (containing styrene-butadiene latex) with an annual output of less than 30 000 tonnes; and new construction, reconstruction or expansion of production units of general-purpose adhesives, such as solvent-based neoprene rubber, styrene-butadiene thermoplastic rubber, polyurethane, and polyacrylate.[625]

The Restructuring Catalogue demonstrates how by explicitly encouraging and supporting the development of certain industries, while discouraging, restricting, and even prohibiting others, the Chinese government has, rather than allowing market forces a free hand, exerted deep and systematic influence on the industrial structure of the country's economy.

A similar dynamic can be seen in the country's FYPs. The treatment of 'non-ferrous metals' in the 13th Non-ferrous Metals FYP demonstrates how policymakers welcome certain types of investment, while restricting others, to a great level of specificity. In the following excerpt, the Plan calls for further development:

In order to fulfil the key basic materials' priorities for high-end sectors such as a new generation of IT, aviation and aerospace, marine engineering, and high-tech shipbuilding, advanced rail transport, energy saving and new energy cars etc., [China shall]

- implement collaborative innovation and smart manufacturing,

[625] Category II Restriction Projects, Section IV of the Restructuring Catalogue (with translation from PKU Law).

- focus on the development of high performance light alloy materials, non-ferrous metals for electronic materials, non-ferrous metals for new energy materials, rare metals materials for deep processing,

- raise materials quality's homogeneity,

- lower cost

- raise the mid & high range effective supply capacity and supply level.[626]

Meanwhile, the same category contains the following more cautionary language:

Taking into account China's increasing dependence on foreign raw materials, the growth slowdown of China's domestic demand in non-ferrous metals as well as the continuously increasing pressure of energy and environmental protection, [China shall]

- strictly control newly established smelting facilities for copper, electrolytic aluminium, lead, zinc, magnesium etc.,

- encourage outdated lead and zinc smelting capacities to proceed to technological reform;

- stick to the implementation of the regulations related to the "State Council guiding opinion on solving serious overcapacities" (2013/41),

- as regards the setting up and technological reform of electrolytic aluminium facilities, strictly implement the production capacity conversion plan maintaining or reducing quantities and ensure publication on the relevant websites;

- duly control the expansion of yellow gold smelting capacities.[627]

The high importance given to national FYPs in Chinese policymaking all but ensures that, when confronted with an investment approval decision involving non-ferrous metals, the authorities will likely pay heed to these considerations. Further, government agencies take such guidance into account as they draft laws, regulations, and policies that affect investment in the corresponding industry. In this way, the State is able to use its industrial policy apparatus to concretely influence the country's economy.

8.2.3. GOAL: UTILIZE FOREIGN INVESTMENT

The Chinese government is currently reforming its system for managing foreign investment – with the stated purpose of transforming its role from one focused on serving as a pre-

[626] Non-ferrous metals 13th FYP, Section IV-3.
[627] Ibid., Section IV-2.

establishment gatekeeper to one more focused on post-establishment regulation.[628] Nonetheless, the government continues to actively play both roles, and is expected to remain intricately involved in determining which kinds of foreign investments are welcome into the country, and which are not, for the foreseeable future.

Increased openness to foreign investment has been an important factor in China's development and China's leaders continue to pledge further opening of the economy. The goals of encouraging investment might be diverse, including development in central and western parts of China,[629] or cultivation of domestic industry capabilities through policies that, among other things, facilitate technology transfer[630] in support of the industrial policy objectives described above.

The central document outlining (though not exclusively) whether or not particular types of investments are to be welcomed or restricted is the Catalogue of Industries for Guiding Foreign Investment ('Foreign Investment Catalogue') (discussed in greater detail in Section 8.3.2.2).[631] The catalogue contains a list of 'encouraged' investments whose contents correlate with policymakers' understanding of China's foreign investment needs.

When foreign investment is seen as detrimental to domestic industry or other national interests, it may be restricted, or even prohibited. Such investments may be placed on the 'restricted' or 'prohibited' lists of the Foreign Investment Catalogue (these two lists taken together are now collectively called the national 'negative list' for foreign investment[632]).

Foreign investors encounter a number of obstacles in China. Section below first describes several policies and notices that seek to attract foreign investment, while guiding the way in which it flows. Further it describes local partner and equity requirements and technology transfer requirements, which are found in the Foreign Investment Catalogue and other key documents guiding foreign investment.

8.2.3.1. Recently Published Notices Seeking to Attract Foreign Direct Investment

In 2017, the State Council issued two notices declaring Chinese policymakers' intentions to attract more FDI into China, and make improvements to the role it plays in the economy.

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[628] See, e.g. 13th FYP, Chapter 50, Section1.
[629] The Catalogue of Priority Industries for Foreign Investment in Central and Western China provides specific guidance for foreign investment in lesser developed central and western parts of the country. Catalogue of Priority Industries for Foreign Investment in Central and Western China (Revised in 2017), Order No.33 of the National Development and Reform Commission and the Ministry of Commerce.
[630] See discussion in Section 8.2.3.3 and Article 14(1) of Decision No 40 listing the principles for the 'encouraged' category: '*Having technical base for research, development and industrialization in China, and being conducive to technical innovations and forming a new economic growth point'* .
[631] Catalogue of Industries for Guiding Foreign Investment (2017 Revision), National Development and Reform Commission and Ministry of Commerce, NDRC Order No. 4 (published 28 June 2017, effective 28 July 2017).
[632] Ibid.

Similar messaging was echoed during the 19th Congress of the Communist Party of China in October 2017.

On 12 January 2017, the State Council published the Measures for Opening Wider to the Outside World and Making Active Use of Foreign Investment[633] ('Notice 5').[634] These measures declare the importance of opening the Chinese economy more to the outside world, creating a level playing field for foreign investment, and making greater efforts to attract it into the country.

On 8 August 2017, the State Council's Several Measures for Promoting the Growth of Foreign Investment ('Notice 39')[635] call for progress toward the following policy goals:

- **Further reduce market entry restrictions for foreign investors:** Promote the full adoption of 'negative lists' at the national level.
- **Formulate supportive fiscal and taxation policies:** Among other things, multinational companies are encouraged to set up headquarters in China, with preferential tax rates and other forms of financial support.
- **Improve the comprehensive investment environment in national-level development zones.**[636]

The kind of prescriptive language found in these documents, and others, lends further support to the view that the Chinese authorities see foreign investment as a means to an end, and continue to be deeply engaged in modulating incentives in order to achieve their preferred configuration of foreign investment in the economy. The 'efforts' proposed in the two documents (e.g. tax exemptions and other preferential treatment, an invitation to set-up headquarters in China, the possibility to reinvest profits abroad) are, above all, addressed towards certain geographical areas (e.g. western and central regions of China, though not exclusively) and certain sectors (e.g. technology and other high value industries).[637]

The following excerpts from these two notices demonstrate, in greater detail, how the Chinese policymakers steer foreign investment flows toward specific sectors:

- […] *Foreign investors are encouraged to invest in high-end manufacturing, smart manufacturing, green manufacturing, etc., as well as industrial design and innovation,*

[633] Notice of the State Council on Several Measures for Opening Wider to the Outside World and Making Active Use of Foreign Investment, Guo Fa 2017, No. 5, 12 January 2017.
[634] Ibid.
[635] Notice of the State Council on Several Measures for Promoting the Growth of Foreign Investment, Guo Fa 2017, No. 39, 08 August 2017.
[636] Ibid., para. 1-12.
[637] Notice of the State Council on Several Measures for Promoting the Growth of Foreign Investment, Guo Fa 2017, No. 39, para. 4-7,8 August 2017.

engineering consulting, modern logistics, inspection, testing and certification, and other production-oriented services to transform and upgrade traditional industries.[638]

- *Foreign investments shall play their positive role in optimizing the structure of trade in services. The preferential income tax policies applicable to service enterprises with advanced technologies that satisfy the prescribed conditions in service outsourcing pilot cities shall be rolled out across the country to guide more foreign investors to invest in high-tech and high value-added services*.[639]

- *National-level development zones shall be supported to enhance their capacities for providing industry supporting services. In regions where conditions are ripe, foreign-owned production supporting service enterprises shall be introduced to develop, on an experimental basis, domestic and overseas maintenance business of high-tech and high value-added projects so as to foster the extension of processing trade to the middle and higher ends of the global industry chain and value chain*.[640]

The following excerpts show how policymakers seek to steer foreign investment flows towards specific geographic areas:

- *Central and western regions and north-eastern regions shall be supported to undertake the transfer of foreign-invested industries. The Catalogue of Priority Industries for Foreign Investment in Central and Western Regions shall be revised to expand the scope of industries in which foreign investment is encouraged in central and western regions and northeastern regions. Preferential policies on enterprise income tax shall be applied to foreign-invested enterprises engaging in industries where foreign investment is encouraged in western regions as long as they meet the prescribed requirements. Foreign-invested enterprises that transfer their operations to central and western regions or north-eastern regions shall enjoy the preferential policies on capital, land, etc. that are introduced by the State to support industrial transfer and processing trade. Where foreign-invested enterprises in eastern regions move operations to central and western regions or north-eastern regions, departments of human resources and social security shall promptly handle the formalities for inter-regional transfer and continuation of social insurance contribution based on applications*.[641]

- *Foreign investors shall be pushed to shift their investment to western China and the old industrial bases in northeastern China. It is necessary to give full play to the role*

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[638] Notice of the State Council on Several Measures for Opening Wider to the Outside World and Making Active use of Foreign Investments, Guo Fa 2017, No. 5, para. 1(4), 12 January 2017.
[639] Notice of the State Council on Several Measures for Promoting the Growth of Foreign Investment, Guo Fa 2017, No. 39, para. 2(4), 8 August 2017.
[640] Ibid., para. 3(12).
[641] Notice of the State Council on Several Measures for Opening Wider to the Outside World and Making Active use of Foreign Investments, Guo Fa 2017, No. 5, para. 3(16), 12 January 2017.

of existing financial funds, and actively support the development of national-level development zones (including economic and technological development zones, high-tech industrial development zones, special customs regulatory zones, etc., hereinafter the same) in western China and the old industrial bases of northeastern China in terms of scientific and technological innovation, ecological and environmental protection, public services and other areas, to improve the investment environment, enhance the quality of the investment attracted and undertake the transfer of high-end manufacturing thereto.[642]

The Catalogue of Priority Industries for Foreign Investment in Central and Western China (see box below) is an example of a comprehensive catalogue designed to coordinate foreign investment in a particular geographic area.

Central and Western China Foreign Investment Catalogue

The *Central and Western China Foreign Investment Catalogue*[643] supplements the Foreign Investment Catalogue in order to achieve a specific purpose, the development of certain geographic regions. This catalogue lists encouraged activities and investment sectors for provinces or regions in central and western China (i.e. Shanxi, Inner Mongolia, Jilin, Heilongjiang, Anhui, Jiangxi, Henan, Hubei, Hunan, Chongqing, Sichuan, Guizhou, Yunnan, Tibet, Shaanxi, Gansu, Qinghai, Ningxia and Xinjiang).[644]

The latest revision of this catalogue, released by NDRC in February 2017, added 139 items to the 2013 version for a total of 639 items.[645] Like other catalogues and industrial policy documents, the Central and Western China Foreign Investment Catalogue serves as a tool for Chinese policymakers to micromanage economic development. See, for instance, the following items in its list of encouraged industries for the Inner Mongolia Autonomous Region:

(5) Refined and deep processing of copper, lead, zinc, magnesium, aluminium and other non-ferrous metals

(6) Comprehensive utilization, refined processing and application of non-metallic minerals (Kaolinite, andalusite, bentonite, dolomite, crystalline graphite, perlite and zeolite) (excluding prospecting and exploitation). […]

(11) Development and utilization of comprehensive utilization technologies such as using ethylene and chlorine to produce PVC of more than 300 000

[642] Notice of the State Council on Several Measures for Promoting the Growth of Foreign Investment, Guo Fa 2017, No. 39, para. 2(7), 8 August 2017.
[643] Catalogue of Priority Industries for Foreign Investment in Central and Western China (Revised in 2017), Order No.33 of the National Development and Reform Commission and the Ministry of Commerce.
[644] Ibid.
[645] Ibid.

tonnes annually through oxychlorination and producing chlorine from waste hydrochloric acid. […]

(15) Development, protection and sustainable utilization of animal and plant medicinal resources: construction of the bases for planting authentic Inner Mongolia medicinal materials and special Mongolian medicinal materials, construction of the conservation and nursery bases for endangered medicinal plants, construction of seedling and seed bases, and construction of the research and development ('R&D') centres for authentic medicinal plant extracts (excluding those included in the categories where foreign investment is restricted or prohibited under the Catalogue for the Guidance of Foreign Investment Industries).

(16) Production of articles specially needed by ethnic minorities, arts and crafts, materials for packaging containers and glass products for daily use, as well as commercial tourist souvenirs with ethnic characteristics. […]

(20) Manufacturing of complete automobiles (the percentage of foreign investment shall be not higher than 50%) and manufacturing of special purpose vehicles (excluding ordinary semi-trailers, dumpers, tank trucks, van vehicles and box/stake trucks) (the percentage of foreign investment shall be not higher than 50%).

(21) Manufacturing of auto parts and components: automatic transmission with six or more gears, high-power and density driving axles for commercial vehicles, adaptive front-lighting systems, LED front-lighting, application of lightweight materials (high-strength steel, aluminium-magnesium alloy, composite plastics, powder metallurgy, high-strength composite fibers, etc.), clutches, hydraulic shock absorbers, central control panel assembly and seats. […]

(29) Construction and operation of pipelines and networks for urban gas supply, heating power and water supply and drainage (the Chinese party as the controlling shareholder in cities with population of more than 500 000).[646]

8.2.3.2. LOCAL PARTNER AND EQUITY REQUIREMENTS

Market access for foreign investors is, in many sectors, limited by requirements that they enter into joint ventures with Chinese partners, or certain restrictions or requirements relating

[646] Catalogue of Priority Industries for Foreign Investment in Central and Western China, Order No.33 of the National Development and Reform Commission and the Ministry of Commerce, (Revised in 2017), Inner Mongolia Autonomous Region.

to equity ownership. Many such requirements can be found in the Foreign Investment Catalogue (discussed in greater detail in Section 8.3.2.2).

For instance, many such requirements can be found within parentheses following items listed in the 'restricted' category of the 2017 version of the Foreign Investment Catalogue:

> *21. Telecom companies: limited to the WTO commitment to open business, value-added telecommunications business (foreign investment ratio of not more than 50% Except for e-commerce), the basic telecommunications business (Chinese side holding). […]*
>
> *26. Insurance companies (life insurance companies do not exceed 50% of foreign investment). […]*
>
> *32. Medical institutions (limited to joint ventures, cooperation). […]*
>
> *34. Cinema construction, operation (Chinese holding).*
>
> *35. Performance brokerage (Chinese holding).*

Other such requirements can be found scattered throughout various other regulatory and policy documents. For instance, Article 6 of the Provisions on the Administration of Foreign-funded Telecommunications Enterprises stipulates:

> *In a foreign-invested telecom enterprise operating basic telecom services (excluding the wireless paging service), the foreign investors' total capital contribution shall not exceed 49%.*
>
> *In a foreign-invested telecom enterprise operating value-added telecom services (including the wireless paging service of basic telecom services), the foreign investors' total capital contribution shall not exceed 50%.*
>
> *The proportional ratio of the capital contribution respectively made by the Chinese investors and foreign investors of a foreign-invested telecom enterprise at different phases shall be determined pursuant to the relevant provisions of the State Council's department in charge of industry and information technology.*[647]

Article 2 (2)(d) of the Opinions Regarding Foreign Investment in Listed Companies states:

> *For those foreign-invested stock companies, which, according to relevant provisions, must be controlled (including being indirectly controlled) by the Chinese parties or for which there are special provisions regarding the percentage of shares that must be held by the Chinese*

[647] Provisions on the Administration of Foreign-funded Telecommunications Enterprises, State Council, Art. 6 (2016 Revision).

partners shall continue to keep their controlling positions or continue to hold the requisite percentage of shares after the foreign-invested stock company is listed on the stock market.[648]

8.2.3.3. TECHNOLOGY TRANSFER REQUIREMENTS

As it seeks to develop the country's technological and innovation capabilities, the Chinese government has been particularly focused on attracting foreign investment to bring needed technologies into the country, and to encourage the transfer of those technologies to, or the cultivation of relevant capabilities amongst, domestic industry players. This has led to the imposition of technology transfer requirements through written measures and, more commonly now, through the structuring of incentives and through unwritten pre-conditions for market access implemented via investment approval processes.[649]

According to the European Chamber of Commerce in China:

> *European companies are confronted by de facto requirements to transfer technology in order to participate in government tenders in China. This rarely happens through formal regulations or tender documents, but through Chinese partners unofficially requiring transfer before agreeing to form joint ventures. Foreign-invested enterprises spend great efforts and make huge investments in R&D in China. However, when they are willing to put a newly-developed technology on the Chinese market they face heavy and intrusive licensing approval processes. These processes often require companies to divulge detailed information related to the new technology, including proprietary information of the company and trade secrets*. [650]

Although explicitly stated technology transfer requirements in laws and regulations are less common than in the past, policy documents and statements make clear that technology transfer remains an important goal of policymakers. For instance, technology transfer may be a necessary result of the structure of another regulatory requirement.

An example can be found in China's evolving regulatory framework for developing its NEV industry and market. In order to support the development of this designated 'strategic emerging industry', MIIT has promulgated the Measures for the Parallel Administration of Corporate Average Fuel Consumption for Passenger Cars and New Energy Vehicle Credits, which will come into effect on April 1, 2018. In accordance with these measures, in order to continue selling traditional energy passenger vehicles in China, manufacturers or importers of such vehicles must earn (or purchase from others) credits for selling a certain proportionate

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[648] *Opinions Regarding Foreign Investment in Listed Companies*, Ministry of Foreign Trade and Economic Cooperation, China Securities Regulatory Commission, Art. 2(2)(d), 8 October 2001.
[649] *See, e.g.* Measures and Practices Restraining Foreign Investment in China, prepared for the European Commission Directorate-General for Trade, August 10 2014. p. 65.
[650] European Chamber of Commerce in China, *European Business in China position paper 2016/2017*, p.141.

number of NEVs. Since it is impractical for most existing manufacturers and importers to import a sufficient number of NEVs to support the current volumes of traditional energy vehicle sales being sold – especially because of the 25% tariff imposed on imported vehicles, foreign manufacturers with manufacturing operations in China are effectively being compelled to begin production of NEVs in China. The Provisions on the Administration of Newly Established Pure Electric Passenger Vehicle Enterprises[651] require applicants for investment project approvals to show how the newly established entity in China will be able to possess research and development centers with relevant capabilities,[652] which means that unless such capabilities can be found domestically (e.g. in the hands of a joint venture partner), this provision necessarily requires the transfer of technology into China. Moreover, since foreign investments in NEVs are subject to the same equity cap of 50% as investments in automobile manufacturing more broadly, this technology must be transferred to a venture that is 50% owned by a local partner or partners. Other regulations similarly condition market entry approvals[653] and financial support[654] for new energy vehicle requirements on similar requirements of R&D capabilities and technical mastery.

While many technology transfer arrangements are fair and consented to, concerns about unfair practices relating to technology and intellectual property transfer have led the U.S. Trade Representative to launch an investigation under Section 301 of the U.S. *Trade Act of 1974*.[655]

8.3. Advancing China's Industrial Policy Goals Through Investment Approval Processes

While Chinese industrial policies find expression in laws and regulations regulating foreign investment, the investment approval process itself allows the authorities to more dynamically apply industrial and economic development policies to proposed investments on a case-by-case basis. This section will analyse how the Chinese government has set up a system for processing private investment applications that allows it to micromanage access to the market and maintain a decisive role in overseeing and influencing the investment decisions of investors – both domestic and foreign.

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[651] 新建纯电动乘用车企业管理规定 (Provisions on the Administration of Newly Established Pure Electric Passenger Vehicle Enterprises), (promulgated by NDRC and MIIT, Jun. 2, 2015, effective Jul. 10, 2015). ('Investment Project Approval Rules').

[652] 新建纯电动乘用车企业管理规定 (Provisions on the Administration of Newly Established Pure Electric Passenger Vehicle Enterprises), Art. 9(1) (promulgated by NDRC and MIIT, Jun. 2, 2015, effective Jul. 10, 2015).

[653] 新能源汽车生产企业及产品准入管理规定 (Rules for the Administration of New Energy Vehicle Manufacturing Enterprise and Product Access), Annex 1 (Items 1 and 2) (promulgated by MIIT, Jan. 6, 2017, effective Jul. 1, 2017).

[654] 组织开展新能源汽车产业技术创新工程的通知 (Notice on Organizing and Launching New Energy Vehicle Industry Technical Innovation Engineering Projects) (promulgated by MOF, MIIT and MOST, Sep. 20, 2012), http://www.miit.gov.cn/n1146295/n1652858/n1652930/n3757018/c3757480/content.html.

[655] See USTR website: *USTR Announces Initiation of Section 301 Investigation of China* https://ustr.gov/about-us/policy-offices/press-office/press-releases/2017/august/ustr-announces-initiation-section

In particular, the chapter examines how government policy is implemented through the approval process via: (1) the inherent structure of the approval process, which is in large part guided by the contents of industrial policy catalogues (especially the Project Approval Catalogue and the Foreign Investment Catalogue) that meticulously, and with great specificity, convert high-level policy guidance into approval requirements and restrictions for investment projects, and (2) substantive criteria applied through administrative discretion granted to approval authorities. The chapter furthermore demonstrates how additional substantive and procedural restraints and requirements apply to foreign investment, implementing China's industrial policy goal of utilizing foreign investment for certain purposes, while keeping it in check.[656]

8.3.1. Overview of Investment Approval Process

Although there are variations in practice, a helpful summary of the key steps in the investment approval processes for domestic and foreign investment can be found in two reports, one commissioned by the EC's Directorate-General for Trade[657] and one by the U.S. Chamber of Commerce.[658] Those reports distinguish between the processes for domestic and foreign investment, but we discuss them together here. The following chart[659] presents, at a high level, the key steps that apply to domestic investors, and eight steps that apply to foreign investors. These steps are carried out by different authorities, and can, to some extent, run in parallel.[660] Items applicable only to foreign investors are shaded in **light red**.

Step	Administrative Discretion	Approval Type
1A	**High**	**AML** *MOFCOM or Local Counterparts*
1B	**High**	**National Security Review** *Inter-Ministerial Panel*
2	**Low**	**Name Registration**

[656] Note that a full analysis of discriminatory treatment of foreign investors vis-à-vis domestic investment is beyond the scope of this report. For more discussion of this topic, *see Measures and Practices Restraining Foreign Investment in China, prepared for the European Commission Directorate-General for Trade*, August 10 2014; Covington & Burling, (2015); *Assessing "National Treatment" as a Basis for Securing Market Access Under a Comprehensive Agreement on Investment with the PRC*, July 23, 2015.
[657] Covington & Burling, (2015). *Assessing "National Treatment" as a Basis for Securing Market Access Under a Comprehensive Agreement on Investment with the PRC*, July 23, 2015.
[658] US chamber of Commerce, (2012). *China's Approval Process for inbound Foreign Direct Investment: Impact on Market Access, National treatment and Transparency.* Available at: https://www.uschamber.com/sites/default/files/documents/files/020021_China_InboundInvestment_Cvr.pdf
[659] Note that this chart has been adapted from a similar chart included in the report prepared for the Directorate-General for Trade. See Covington & Burling, (2015). *Assessing "National Treatment" as a Basis for Securing Market Access Under a Comprehensive Agreement on Investment with the PRC*, July 23, 2015
[660] Covington & Burling, (2015). *Assessing "National Treatment" as a Basis for Securing Market Access Under a Comprehensive Agreement on Investment with the PRC*, p. 18, July 23, 2015.

		AIC
3	**Medium**	**Project-Related Approvals (e.g., environmental permits)** *Various Authorities*
4a ***or*** **4b**	**High**	**Project Approval** *Various Authorities (E.g. State Council, NDRC, Industry-Specific Regulators (Central and Local))*
	Low	**Project Filing** *Local DRC*
5	**High**	**Licensing** *Industry Regulator*
6a ***or*** **6b**	**High**	**Enterprise Approval** *MOFCOM or Local Counterparts*
	Low	**Enterprise Filing** *Local Counterparts of MOFCOM*
7	**Low**	**Enterprise Registration** *AIC*

Although a full description of each step is beyond the scope of this report, some of these steps will be discussed in greater detail in the following sub-sections.

The Chinese government is currently in the process of reforming its systems for managing investment in China by foreign investors, investment in China by domestic investors, and outbound investment by Chinese investors. With respect to foreign and domestic investment into China, the preferred approach appears to be what is referred to as a 'negative list' approach, in which restrictions are included on a single, consolidated list. The government is expected to release a national market access negative list that applies to all investment activity (both domestic and foreign) in China in 2018.[661] In theory, investments listed as restricted on this negative list will be subject to certain pre-establishment approvals and restrictions, while other investments will be free to proceed with a simpler record filing requirement (the negative list would also include prohibited items, for which market access would not be permitted at all).[662] Similarly, an additional negative list applies to foreign investments in China, and determines (by omission from the list) which investment projects may proceed

[661] Opinions of the State Council on Implementing the Market Access Negative List System, State Council, para. 11, 2 October 2015.
[662] Ibid., para. 6.

without enterprise approval (Step 7), and which still need to go through that extra step.[663] For now, the operative 'negative list' for foreign investment is simply composed of the 'restricted' and 'prohibited' lists of the familiar Foreign Investment Catalogue taken together. Although it may be policymakers' eventual goal, at this point, it does not appear that investors can rely on either negative list as a comprehensive list of market access restrictions.

While some hope that the clear listing of all restrictions and prohibitions on consolidated negative lists will make it easier to pare back restrictions and lead to market openings in the future, whether that hope will be borne out remains to be seen. For now, even if restrictions and requirements are so consolidated, the fact remains that a wide range of private investment activities are subject to extensive management by the state. The thresholds to determine whether a project by a private Chinese investor within China would require the investment approvals are not generally applicable. These are usually set out in the Project Approval Catalogue and narrowly tailored to specific industries/types of projects. The Catalogue provides more detailed guidance as to which projects in which industries require project approval, and which authorities are authorized to provide it.

The ongoing reforms, and any resulting streamlining of approval requirements, will help the government to better focus limited official resources on investment activity of particular concern (e.g. larger or more sensitive investments).

The reforms to the management of outbound Chinese investment are described separately in Section 8.3.2.1.

8.3.2. INDUSTRIAL POLICY CATALOGUES

Industry policy catalogues, which have been given binding effect by certain regulations, play an important role in converting high-level industrial policy directions into detailed prescriptions for the treatment (restrictions, approval conditions) of different types of investments. Chief among these catalogues are the Project Approval Catalogue and the Foreign Investment Catalogue.

8.3.2.1. PROJECT APPROVAL CATALOGUE

Project approval, Step 4 in the chart above, allows Chinese government officials at NDRC, its local counterparts, and other involved government entities, to make sure that projects in sensitive or important industry sectors are carefully managed and coordinated. The Catalogue of Investment Projects Subject to Approval of the Government[664] ('Project Approval Catalogue'), first promulgated in 2004, directs investors and officials as to which investment projects require project approval before they may proceed.

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[663] Catalogue of Industries for Guiding Foreign Investment (revised in 2017), NDRC and MOFCOM, promulgated June 28, 2017, effective Jul. 28, 2015.
[664] Catalogue of Investment Projects Subject to Government Verification and Approval, State Council (amended 12 Dec. 2016).

Fixed asset investment projects included in the Project Approval Catalogue must generally obtain project approval from NDRC or industry regulators under the State Council, or from their respective counterparts at the provincial or local government levels.[665] Investment projects not included in the Project Approval Catalogue (and not otherwise restricted or prohibited by other statutory provisions) do not require project approval. Such projects are still technically subject to record-filing requirements.[666] However, because the regulatory authorities responsible for project approval mainly focus their attention on business sectors that are more 'industrial' in nature, project filing requirements are often ignored in practice for non-fixed asset investments not listed in the Project Approval Catalogue.[667]

The current version of the Project Approval Catalogue was promulgated on 12 December 2016,[668] and describes investment projects subject to approval that fall into the following ten industry sectors:

- Agriculture and irrigation;
- Energy,
- Transportation,
- IT,
- Raw materials,
- Machinery manufacturing,
- Light industry,
- New and high-end technology,
- City infrastructure, and
- Social undertakings.

The Project Approval Catalogue does not provide a blanket rule for all investments in these categories. Instead, it provides more detailed instructions—e.g. responsible government agency and level – for how the project approval requirement is to apply to specific types of investments falling within each of the categories listed above. See, for instance, the relevant sections requiring project approval for investments in energy, machinery manufacturing, and light industry:

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[665] Covington & Burling, (2015). *Assessing "National Treatment" as a Basis for Securing Market Access Under a Comprehensive Agreement on Investment with the PRC*, p. 22, July 23, 2015.
[666] Ibid.
[667] Ibid.
[668] Notice of the State Council on Promulgating the Catalogue of Investment Projects Subject to Government Verification and Approval (Guo Fa [2016] No. 72). http://www.gov.cn/zhengce/content/2016-12/20/content_5150587.htm

2. Energy	
Hydropower stations	Projects of building hydropower stations over transboundary rivers or rivers crossing provinces (or autonomous regions or municipalities directly under the Central Government) with gross installed capacity of 500 000 KW or above for a single station shall be subject to the approval of competent investment department under the State Council, of which, the projects with gross installed capacity of 3 million KW or above for a single station or the projects involving 10 000 or above displaced residents shall be subject to the approval of the State Council. The other projects shall be subject to the approval of the local governments.
Pumped-storage hydropower stations	Projects in this category shall be subject to the approval of provincial governments in accordance with relevant planning approved by the State.
Fossil-fuel power station projects (including self-powered station)	Projects in this category shall be subject to the approval of provincial governments, of which, coal-fired and gas-fired thermal power projects shall be approved in accordance with the construction planning formulated by the State based on total number control.
Thermal power station projects (including self-powered station)	Projects in this category shall be subject to the approval of local governments, of which, extraction condensing coal-fired thermal power projects shall be subject to the approval of provincial governments in accordance with the construction planning formulated by the State based on total number control.
Wind power station projects	Projects in this category shall be subject to the approval of local governments in accordance with the construction planning and annual development guiding scale formulated by the State based on total number control.
Nuclear power station projects	Projects in this category shall be subject to the approval of the State Council.
Power grid projects	Power transmission projects of ± DC 500KV or above that involve multiple countries or multiple provinces (or autonomous regions or municipalities directly under the Central Government), and projects of AC 500KV, 750KV or 1 000KV power transmission that involve multiple countries or multiple provinces (or autonomous regions or municipalities directly under the Central Government), shall be subject to the approval of competent investment department under the State Council, of which, the projects of ± DC 800KV or above and the projects of AC 1 000KV shall be filed to the State Council for record; power transmission projects of ± DC 500 KV or above that do not involve multiple countries or multiple provinces (or autonomous regions or municipalities directly under the Central Government), and power transmission projects of AC 500KV, 750KV or 1 000KV that do not involve multiple countries or multiple provinces (or autonomous regions or municipalities directly under the Central Government), shall be subject to the approval of provincial governments in accordance with relevant planning formulated by the State; other projects shall be subject to the approval of local governments in accordance with relevant planning formulated by the State.
Coal mines	The new coal development projects with an annual production capacity of 1.2 million tonnes or above in the mining areas planned by the State shall be subject to the approval of the industry management departments under the State Council, of which, the new projects with a production capacity of 5 million tonnes or above shall be subject to the approval of competent investment department under the State Council and be filed to the State Council for record; other coal development projects within the mining areas planned by the State and common coal development projects shall be subject to the approval of provincial governments. The projects which are prohibited from construction by the State or

	included in the scope of projects subject to withdrawal or elimination shall not be approved.
Coal-to-fuel projects	The coal-to-natural gas projects with an annual output of over 2 billion m^3, and the coal-to-liquid projects with an annual output of over 1 million tonnes shall be subject to the approval of competent investment department under the State Council.
Liquefied petroleum gas receiving and storage facility projects (excluding the supporting projects for oil and gas fields and refineries)	Projects in this category shall be subject to the approval of local governments.
Imported liquefied petroleum gas receiving, storage and transportation facility projects	The newly-built projects (including expansion projects in a new region) shall be subject to the approval of relevant industry management departments under the State Council, of which, the newly-built projects with a receiving, storage and transportation capacity of 3 million tonnes or above shall be subject to the approval of competent investment department under the State Council and be filed to the State Council for record. Other projects shall be subject to the approval of provincial governments.
Oil pipeline network projects (excluding gathering and transportation pipeline networks in oilfields)	The transboundary and cross-provinces (or autonomous regions or municipalities directly under the Central Government) main line pipeline network projects shall be subject to the approval of competent investment department under the State Council, of which, the transboundary projects shall be filed to the State Council for record. Other projects shall be subject to the approval of local governments.
Gas pipeline network projects (excluding gathering and transportation pipeline networks in oil and gas fields)	The transboundary and cross-provinces (or autonomous regions or municipalities directly under the Central Government) main-line pipeline network projects shall be subject to the approval of competent investment department under the State Council, of which, the transboundary projects shall be filed to the State Council for record. Other projects shall be subject to the approval of local governments.
Oil refining projects	The newly-built refinery projects and the expansion of primary processing refining projects shall be subject to the approval of provincial governments in accordance with relevant planning approved by the State. Any newly-built refinery projects and the expansion of primary processing refining projects that have not been included in relevant planning approved by the State shall be prohibited from construction.
Denatured fuel ethanol	Projects in this category shall be subject to the approval of provincial governments.
6. Machinery Manufacturing	
Automobile projects	The projects shall be governed by the Policy on the Development of the Automotive Industry approved by the State Council. Among them, the newly-built Sino-foreign joint-venture car manufacturer projects shall be subject to the approval of the State Council; the newly-built purely electric passenger vehicle manufacturer projects (including the existing vehicle manufacturer switch to purely electric passenger car) shall be subject to the approval of the competent investment department under the State Council; other projects shall be subject to the approval of provincial governments.
Pumped-storage hydropower stations	Projects in this category shall be subject to the approval of provincial governments in accordance with relevant planning approved by the State.

7. Light Industry	
Tobacco Project	The cigarette and diacetate cellulose and tows projects shall be subject to the approval of the industrial administrative department under the State Council.[669]

In certain situations, the Project Approval Catalogue points to other sources for determining the applicable project approval rules. For example, language under the 'machinery manufacturing' section states that the rules applicable to automobile manufacturing are to be found in the Development Policies of the Automobile Industry approved by the State Council. According to these policies, projects of newly-established Sino-foreign joint venture sedan manufacturing enterprises are subject to approval by the State Council. Projects of newly-established pure electric vehicle manufacturing enterprises (and new pure electric passenger vehicle product lines by existing automobile manufacturers) are subject to approval by NDRC. All other projects falling into the automobile category require project approval by corresponding provincial governments.[670]

In addition to investments in the ten industry categories listed above, the Project Approval Catalogue also mentions that certain other types of Chinese outbound investments and foreign investments into China[671] may also be subject to verification and approval.

Outbound Chinese investments involving sensitive countries and regions[672] or sensitive industries[673] are also subject to verification and approval by NDRC. Other outbound projects with investment valued at more than USD 300 million are to be reported to NDRC for record-filing.[674]

New draft Administrative Measures for Enterprise Outbound Investment, like efforts to reform the regulation of domestic and foreign investment, streamline and improve certain aspects of approvals required for outbound investment while maintaining or even tightening

[669] Catalogue of Investment Projects Subject to Government Verification and Approval, State Council, Section II (amended 12 Dec. 2016). Translation obtained from LexisNexis.
[670] Ibid., Section VI
[671] This applies to investment projects already subject to approval based on their categorization in the Foreign Investment Catalogue: i) investment projects worth over USD 300 million in the restricted list should be approved by NDRC; ii) investment projects worth over USD 2 billion in the restricted list should be submitted to the State Council; and iii) investment projects worth less than USD 300 million in the restricted list should be verified by provincial governments.
[672] According to the draft 'Administrative Measures for Enterprise Outbound Investment', issued by NDRC November 3, 2017, 'Sensitive countries and regions' include those with which China does not have diplomatic relations, are experiencing war or internal strife, or where investment is prohibited by Chinese treaties and accords.
[673] According to the draft 'Administrative Measures for Enterprise Outbound Investment', issued by NDRC November 3, 2017, 'Sensitive industries' include (i) military equipment development, manufacturing, or maintenance, (ii) cross-border water projects, (iii) news media, and (iv) other industries to be restricted according to China's macro-control policy.
[674] Catalogue of Investment Projects Subject to Government Verification and Approval, State Council, Section XII (amended 12 Dec. 2016).

control over investment activities of particular interest.[675] These new draft measures eliminate provincial-level DRC reviews (allowing for direct application to NDRC at the central level), eliminate a requirement that outbound investors file a project information report and receive a confirmation letter before beginning substantive work on an outbound investment project, and allow outbound investors to go through NDRC verification and approval after the signing or closing of a deal (must still be prior to 'implementation').[676] At the same time the draft measures extend the reach of this approval requirement to investments by foreign entities (including in Hong Kong, Macau, and Taiwan) 'controlled' by Chinese entities and individuals.[677] A list of sensitive industries is to be set forth in a published schedule.[678]

8.3.2.2. FOREIGN INVESTMENT APPROVAL CATALOGUE

Certain investments that would not be subject to project approval if conducted by domestic investors may be subject to project approval if carried out by foreign investors. The Foreign Investment Catalogue, which also determines the applicability of enterprise approval requirements, also determines which foreign investments are to receive additional project approval scrutiny. The additional project approval and enterprise approval requirements give Chinese authorities additional levers to manage where and how foreign investment is used in the Chinese economy.

Central to the regime for managing foreign investment in China since it was first issued in 1995 is the Catalogue of Industries for Guiding Foreign Investment ('Foreign Investment Catalogue' or 'FIC'), adopted jointly by NDRC and MOFCOM.[679]

Industries in the Foreign Investment Catalogue are classified into one of three categories: (a) encouraged investments, (b) restricted investments, and (c) prohibited investments. Types of investments not listed in the Catalogue are considered to be permitted. In the most recent iteration of the Catalogue – the FIC (2017 Revision) – the lists of restricted and prohibited investments are collectively referred to as a 'negative list' for foreign investment in the country (as mentioned above in Section 8.3.1).

The *encouraged category* covers industries in which foreign investment is provided with the warmest welcome. Industries in this sector may benefit from greater flexibility and from certain tax and other investment incentives. This category includes a number of high-tech and advanced manufacturing sectors, such as those relating to aerospace and pollution control.

The *restricted category* covers industries in which foreign investment is subject to a higher level of government scrutiny, limitations on the choice of corporate forms (such as mandatory

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[675] Administrative Measures for Outbound Investment by Enterprises (Draft for Comments), NDRC (promulgated 3 Nov. 2017).
[676] Ibid., Article 7, 13, 32
[677] Ibid., Article 62 and 63
[678] Ibid., Article 13
[679] Catalogue of Industries for Guiding Foreign Investment (2017 Revision), National Development and Reform Commission and Ministry of Commerce, NDRC Order No. 4 (published 28 June 2017, effective 28 July 2017).

joint ventures), and ownership ceilings. Such restrictions apply, for instance, to certain sub-sectors within the services sector, including banking and insurance.

Foreign investments that fall under the *prohibited category* are, simply, not permitted at all. This category includes, for example, domestic postal services.

The detailed lists in the Foreign Investment Catalogue play an important role in determining which projects China's economic planners believe should receive extra scrutiny through project approval (Step 4) and enterprise approval (Step 6):

FIC & *Project* Approval. All projects that would have been subject to project approval if conducted by domestic investors are also subject to project approval when conducted by foreign investors. In addition, foreign investment projects included in the restricted list of the Foreign Investment Catalogue must also go through project approval,[680] with the level of approval required (e.g. central-level, provincial level) basically determined by the value of the proposed investment.[681] These monetary thresholds allow central-government officials to focus their resources on ensuring that bigger ticket foreign investments conform to government policy, with subordinate agency officials delegated responsibility to manage smaller investments. Some items may be listed in both the encouraged and restricted lists – they are encouraged investments, but are subject to certain market entry restrictions (e.g. foreign equity ceilings, joint venture requirements). Encouraged list rules apply to these projects provided that they comply with the delineated market entry restrictions.[682]

FIC & *Enterprise* Approval. Conducted by MOFCOM and its local counterparts, enterprise approval only applies when foreign investment is involved. In the past, all foreign investments, unless otherwise exempted (e.g. through more liberal policies in China's pilot free trade zones), were subject to enterprise approval by commerce authorities. As of 30 July 2017, the process has been streamlined (see discussion in Section 8.3.1), with only investments listed on a nationwide negative list for foreign investment – at least for now, the 'restricted' and 'prohibited' lists of the Foreign Investment Catalogue – remaining subject to enterprise approval.[683] All other foreign investments are, in theory, considered permitted

[680] Catalogue of Investment Projects Subject to Government Verification and Approval, State Council, Section XI (amended 12 Dec. 2016).
[681] Covington & Burling, (2015). *Assessing "National Treatment" as a Basis for Securing Market Access Under a Comprehensive Agreement on Investment with the PRC*, July 23, 2015, p. 22-25.
[682] Catalogue of Industries for Guiding Foreign Investment (2017 Revision), Notes of Negative List for the Market Entry of Foreign Investment, Article 5 (NDRC and MOFCOM).
[683] The negative list approach for foreign investment was first tested in China's pilot free trade zones, before regulators started rolling it out on a nationwide basis. A separate negative list applies in those zones. While the goal of a negative list is generally for it to serve as an exclusive list of deviations from more open market access or national treatment, this negative list cannot yet be relied upon as such. Other laws, regulations, and policy documents may still impose additional restrictions on foreign investment activity.

unless otherwise specified, and may proceed with a simpler record filing, instead of having to go through the full enterprise approval process.[684]

In cases where enterprise approval is still required, it is a prerequisite for AIC enterprise registration (Step 7).[685] Moreover, in such cases, it is also a precondition for the effectiveness of certain corporate agreements, e.g. those under the Sino-foreign joint venture agreement or share purchase agreement.[686]

As with the Project Approval Catalogue, a glance at the specific line items contained in the Foreign Investment Catalogue shows a level of detail that corresponds with a desire on the part of the Chinese authorities to micromanage investment activity, and steer the country's economy.

The following, unremarkable excerpt from the list of encouraged investments includes the following manufacturing-related items in the 'metal products industry' (96-99) and the 'general equipment manufacturing industry' (100-109):

> *96. Research, development, and manufacture of new light-weight and environment-friendly materials for aviation, aerospace, automobiles and motorcycles (including special-purpose aluminium sheets, aluminium-magnesium alloy materials and aluminium alloy motorcycle frames)*
>
> *97. Research, development and manufacturing of light metal semi-solid rapid prototyping materials*
>
> *98. Manufacture and processing (including painting and processing inner and outer surface of the products) of metal packing products (complete products, with wall thickness < 0.3mm) used for packing all kinds of grain, oil and food, vegetables, fruits, beverages, and household chemical products.*
>
> *99. Manufacture of nickel-free stainless steel products.*
>
> *100. Manufacture of high-end computer numerical controlled (CNC) machine tools and key spare parts: five-axis alignment CNC machine tools, CNC*

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[684] Decision of the Standing Committee of the National People's Congress on Revising the Law of the People's Republic of China on Foreign-invested Enterprises and Other Three Laws, effective 1 October 2016.
[685] Law of the People's Republic of China on Sino-Foreign Equity Joint Ventures, Articles 3 and 15 (NPC, amended 2016).
[686] Law of the People's Republic of China on Sino-Foreign Equity Joint Ventures (2001 Amendment)] ('EJV Law'), Article 3 (NPC, *amended* 2016): '*Equity joint venture agreements, contracts and articles of association to which the various parties to an equity joint venture are signatories shall be submitted to the state department in charge of foreign economics and trade (hereinafter referred to as an examining and approval authority) for examination and approval. An examining and approval authority shall decide whether or not to grant the approval within three months. Once approved, an equity joint venture shall register with a state administration for industry and commerce ~ operations after obtaining a business license*.'

coordinate boring and milling processing centre, and CNC coordinate grinding machines.

101. Manufacture of multi-station forging forming machines of 1 000 tonnes or above.

102. Manufacture of equipment for dismantling, crushing, and post-processing and sorting of retired automobiles.

103. Manufacture of flexible transfer lines (FTL).

104. Manufacture of vertical multi-joint industrial robots and welding robots and welding apparatus and equipment thereof.

105. Manufacture of sub-micron and ultra-fine grinders.

106. Manufacture of wheeled and crawler cranes of 400 tonnes or above.

107. Design and manufacture of high-pressure plunger pumps of working pressure ≥35MPa and engines, and low-speed large-torque engines of working pressure ≥35Mpa.

108. Manufacture of integrated hydraulic-pressure multiple unit valve of working pressure ≥25MPa, and electro-hydraulic proportional servo elements.

109. Design and manufacture of valve terminal, pneumatic solenoid valve of less than 0.35W and high-frequency electrically-controlled gas valves of more than 200Hz.[687]

The following excerpt from the list of restricted investments, again, shows how specific the Foreign Investment Catalogue's prescriptions can be:

24. Construction and operation of gas stations (in the case of the same foreign investors selling product oil of different varieties and brands from multiple suppliers through more than 30 chain gas stations, the Chinese parties shall be the controlling shareholders)

25. Banks (the proportion of investment in capital in a Chinese-funded commercial bank by a foreign financial institution and the affiliated party under common control as promoter or strategic investor shall not exceed 20%, while the proportion of investment in capital in a Chinese-funded commercial bank by more than one foreign financial institution and the affiliated party under common control as promoter or strategic investor shall not exceed 25%; the foreign financial institutions investing in China's small or middle-sized financial institutions in rural areas must be banking financial institutions; the foreign

[687] Catalogue of Industries for Guiding Foreign Investment (2017 Revision),Article 96-109 of the Catalogue of Industries in which Foreign Investment is Encouraged, NDRC Order No. 4 (published 28 June 2017, effective 28 July 2017).

investors establishing foreign bank branches, wholly foreign-funded banks and joint Chinese-foreign banks, the sole or controlling shareholder must be foreign commercial banks, while non-controlling shareholders may be foreign financial institutions).[688]

Taken together the similarly detailed 348 encouraged items, 35 restricted items, and 28 prohibited items in the Foreign Investment Catalogue suggest that careful thought has been put into thinking about how investment policy can further China's economic development goals.

8.3.3. ADMINISTRATIVE DISCRETION

Approval requirements play an important role in enabling Chinese government authorities to manage the economy, with each approval requirement creating an opportunity for officials to exercise varying levels of discretion in deciding if and how an investment project goes forward. Officials tasked with approving investment projects are expected to apply substantive criteria particular to the approval requirement. However, substantive criteria can often be vague, and the amount of discretion granted to authorities when tasked with applying them broad. This wide discretion serves as a channel for officials to (1) apply industrial and economic development policies and other government priorities on a case-by-case basis, (2) apply non-public or unwritten policy guidance, and (3) impose their own views and interests. Investors may receive informal, oral instructions from officials that go beyond the requirements of the law.[689]

One can gain a sense of the amount of discretion Chinese authorities reserve and apply at various points in the approval process by considering the evaluation criteria applicable to each step in the process. Some high-level notes on steps identified as involving high levels of discretion follow:[690]

Anti-Monopoly Review. MOFCOM assesses the potential impact of an investment on competition by considering the degree of market concentration, and the impact of the concentration on technological development, consumer welfare, and national economic development.

National Security Review. Applicable only to foreign investors when certain triggering conditions (generally relating to whether the investment involves military or national security-related industries, broadly defined) are met, national security reviews assess proposed mergers

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[688] Catalogue of Industries for Guiding Foreign Investment (2017 Revision), Part I, Article 24 and 25 of the Catalogue of Restricted Industries for Foreign Investment NDRC Order No. 4 (published 28 June 2017, effective 28 July 2017). http://www.fdi.gov.cn/1800000121_39_4851_0_7.html (accessed on 19 December 2017).

[689] Covington & Burling LLP, (2014). *Measures and Practices Restraining Foreign Investment in China, prepared for the European Commission Directorate-General for Trade*, August 10 2014. Section 3.3.

[690] Covington & Burling, (2015). *Assessing "National Treatment" as a Basis for Securing Market Access Under a Comprehensive Agreement on Investment with the PRC*, Sections 2.1 & 2.2, July 23, 2015.

and acquisitions based on their impact on national defence and security, the operational stability of the national economy, social order, and R&D capacity for key national security-related technologies.

Project Approval. Project approval authorities are tasked with evaluating consistency with relevant laws, regulations, and policies; assessing compliance with development planning, industrial policies, and technical policies and standards; determining potential effects on national, economic, and ecological security; and reviewing potential adverse effects on the public interest, especially the local public interest.

Licensing. Industry regulators have broad leeway to regulate industries within their domain, creating, granting, and administering various industry licenses and license-type approvals.

Enterprise Approval. MOFCOM and its local counterparts evaluate affected foreign investments for harm to China's sovereignty, and social and public interests; risks to national security; violations of laws, regulations, and industrial policies; inconsistency with national economic development goals; environmental pollution risks; and, where the foreign-invested enterprise is an equity joint venture, obvious unfairness to the joint venture party.

Even record filing requirements – seen as reduced burdens on investors (and strained officials) – can involve some level of administrative discretion. This is described explicitly in the official notice that accompanied the latest version of the Project Approval Catalogue:

> 9. *As regards projects for which examination and approval for registering and management have been abolished, project registration authorities shall strengthen checks against development plans, industry policy and entry criteria; Administrations in charge of the industry management, together with authorities in charge of urban and rural planning, land management, environmental protection and safety monitoring shall strengthen guidance and restrictions over projects, in accordance with their respective responsibilities*.[691]

The following paragraph of the same notice, intended to address serious overcapacity problems, demonstrates how record-filing and examination and approval requirements, more broadly, can be used as a roadblock to an investment project (emphasis added):

> *4. Projects of iron and steel, electrolytic aluminium, cement, flat glass, shipbuilding and other industries with serious overcapacity shall be strictly governed by the Guiding Opinions of the State Council on Resolving Severe Industry Overcapacity (Guo Fa [2013] No. 41). Any region and department may not register any project that adds new capacity in any other name or by any means, and all relevant departments and agencies may not process relevant*

[691] Notice of the State Council on Promulgating the Catalogue of Investment Projects Subject to Government Verification and Approval (Guo Fa [2016] No. 72). http://www.gov.cn/zhengce/content/2016-12/20/content_5150587.htm (accessed on 19 December 2017).

formalities such as those for land (sea waters or uninhabited islands) supply, energy assessment, environmental impact assessment, examination and approval, new credit support, etc., and shall work together to further severe overcapacities.

As regards coal mining projects, the Opinions of the State Council on Resolving Overcapacity on the Coal Industry and Achieving Development Recovery (Guo Fa [2016] No. 7) shall be strictly implemented. In principle, as of 2016, the approval of new coal mining projects, the examination of technological transformation projects increasing production capacity as well as of production capacity verification and increase projects shall be suspended for a period of three years. For any newly-built coal mine needed, a volume reduction or conversion shall be implemented [elsewhere].

The production capacity of traditional fuel vehicles shall be strictly controlled: in principle any newly building of traditional fuel vehicle manufacturing enterprise shall not be examined and authorised. Active guidance shall be given for the sound and orderly development of new energy vehicles. Newly-built new energy car manufacturing enterprise must have capacities in key technologies and in comprehensive vehicle-related R&D such as power systems, in accordance with relevant requirements such as the "Regulation on the management of newly-built enterprises manufacturing pure electric passenger vehicles". [692]

Broad discretion and a lack of transparency and accountability further allow government officials charged with administering approval requirements to insert additional, conditions on investors, even those not explicitly required by applicable laws and regulations. One example, mentioned in Section 8.2.3.3, is a longstanding complaint of foreign investors in China that officials unofficially condition market access approvals on foreign investors transferring certain technologies into China.

8.4. CHAPTER SUMMARY

Over the past four decades, China has liberalized market access for both domestic and foreign investment. However, the State still maintains significant control and influence over private investment through industrial policies, laws, regulations, and approval processes for investment. The government's reach extends not just to private domestic and foreign enterprises, as well as to Chinese SOEs, seeking to make investments within China, but also to Chinese companies investing overseas.

Chinese government authorities use investment screening as an important tool for supporting industrial policy goals, such as: maintaining state control over key sectors (including by enabling and protecting state-owned enterprises through incentives as well as restrictions on

[692] Ibid.

private investment), bolstering domestic industry (by fostering indigenous innovation, promoting domestic champion companies, and conducting industrial restructuring when the status quo is out of date), and attracting, but keeping in check, foreign investment (to fill gaps in the domestic economy and cultivate domestic industry capabilities).

Industrial policy goals are expressed and implemented during the investment screening process through (1) laws, regulations, and policy documents that describe broad policy directions as well as, often in great detail and specificity, the role that different economic actors and resources should play; and (2) the structure of and substantive criteria applied through the approval processes used to manage private investment. The detail and specificity of written policy prescriptions – which, for example, can be seen in the Project Approval and Foreign Investment Catalogues, indicate that the Chinese government continues to micromanage the country's economy.

The formulation of legal, regulatory, and policy measures, and the day-to-day management of approval processes relating to foreign investment are handled by a range of government agencies, including the NDRC, MOFCOM, AIC and other industry regulators charged with granting various licences (together with the local counterparts of these government agencies).

Although the Chinese government is implementing reforms affecting both domestic investment and foreign investment – including an ambitious effort underway to unify the country's legal regime under a single, comprehensive Foreign Investment Law that codifies recent reform trends – these reforms do not reduce the role of the State in managing private investment. On the contrary, they appear to be used as a means to strengthen the hand of the State by making its influence over the economy better targeted and more efficient.

Part II

DISTORTIONS IN THE PRODUCTION FACTORS

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9.1. INTRODUCTION

According to the Constitution, there is no private land ownership in China. The land is divided into urban land belonging to the State and rural or suburban land belonging to the collectives.[693] Whereas there is no private land property, individuals and organisations can hold land-use rights which allow their holders to dispose of the land to some extent. Land-use rights of urban land provide for more freedoms with regard to the purpose of use and are more easily transferable, while the rural land-use rights come with a number of limitations including a prohibition of non-agricultural use. The land-use rights can be traded under certain conditions.

Even though a number of laws appear to set clear rules with regard to land used for commercial purposes, those laws are in practice often not fully implemented. For example there are legal provisions on the minimum price for land use and auctions which could in theory ensure market-based prices and fair access to land in China. However, as discussed below, in practice a number of buyers (in particular SOEs) received their land for free or

[693] Article 10 of the Constitution reads: '*Land in the cities is owned by the State. Land in the rural and suburban areas is owned by collectives except for those portions which belong to the State as prescribed by law; house sites and privately farmed plots of cropland and hilly land are also owned by collectives. The State may, in the public interest and in accordance with law, expropriate or requisition land for its use and make compensation for the land expropriated or requisitioned. No organization or individual may appropriate, buy, sell or otherwise engage in the transfer of land by unlawful means. The right to the use of land may be transferred according to law. All organizations and individuals using land must ensure its rational use.*'

participated in fictitious tenders with only one participant, obtaining the land use rights at a very low price.

9.2. DEVELOPMENT OF THE LEGAL FRAMEWORK

The process of nationalisation and collectivisation of land in China began in 1956, when the government institutionalized the collective ownership of rural land. The urban land was owned by the State and reallocated into work units ('*danwei*'). As from the late 60s, 'joint state-private ownership' was introduced in order to nationalize also non-land properties such as housing.

Under the Land Policy Reform of 1981, a new policy called Household Responsibility System ('HRS') was adopted in rural areas. According to HRS, rural collectives maintained the ownership but subcontracted their land out to individual households for a certain period of time in exchange for a percentage of their output.[694] Although collective ownership was maintained, the farmers obtained much broader rights to rural land.

The Land Administration Law of 1986 laid down rules for land ownership by the State and the collective as well as rules on land expropriation. In 1988 the Land Administration Law was amended and provisions were introduced allowing for the transfer of the right to use of both types of land.[695]

Legal rules specifying the modalities of the land-use rights' transfer were for the first time set out in The Provisional Regulations on the Grant and Transfer of the Right to Use State-owned Land in Cities and Towns of 1990. The document specified the rules with respect to duration and conditions of land-use rights, the procedural aspects of the land-use rights transfer, as well as requisition by the state.

One of the main developments with regard to the rural land was the adoption of the Law on Land Contract in Rural Areas[696] which entered into force in 2003. This law for the first time specified the rights of the farmers in Article 16 including the right to:

> *(1) in accordance with law, they have the right to use and enjoy benefits from the land covered by the contract as well as the right to circulate the land exploitation rights,*
>
> *and*

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[694] Wong, V . (2014). *Land Policy Reform in China: Dealing with Forced Expropriation and the Dual Land Tenure System* Centre for Comparative and Public Law Faculty of Law The University of Hong Kong, , Occasional Paper No. 25, May, page 14 available at https://www.law.hku.hk/ccpl/pub/OP%20No%2025%20Vince%20Wong.pdf.

[695] Land Administration Law (1986, last amended 2004), Article 2: '*No units of individuals may encroach on land or illegally transfer it through buying, selling or other means. However, the right to use of land may be transferred in accordance with law*'.

[696] Law of the People's Republic of China on Land Contract in Rural Areas (2002).

-they have the right of autonomous organisation of production and exploitation and the right to dispose the products.

(2) they have the right to obtain compensation in accordance with law, in cases of legal requisition or occupation of the land covered by the contract.[697]

Other main changes included the requirement to produce a written contract (Article 21), the prohibition of land readjustment[698] during the 30-year term of contract (Article 27) and an introduction of provisions on dispute resolution (Articles 21 and 52). The system still prohibited non-agricultural use of land.

The Property Law of the People's Republic of China (2007) introduced an explicit distinction between ownership rights and use rights (including *usufructuary* rights, which in turn include the right of possession, the right of use and the right to seek profit from property owned by another party, Article 117). Holders of urban land-use rights have preferential treatment compared to rural land-use rights holders, as they are able to use land for '*constructing buildings, fixtures and their auxiliary facilities*' and to profit from them (Article 135). Urban land-use rights holders can also '*transfer, exchange, use as equity contributions, endow or mortgage*' their rights (Article 143).

9.2.1. RULES GOVERNING LAND-USE RIGHTS TRANSACTIONS

The land-use rights provisions in China are governed by the Land Administration Law of the People's Republic of China (amended in 2004). In addition, the following legal instruments regulate land-use rights: Law of the People's Republic of China on Urban Real Estate Administration (amended in 2007, 'Law on Administration of Urban Real Estate'); the Interim Regulations of the People's Republic of China Concerning the Assignment and Transfer of the Right to the Use of the State-owned Land in the Urban Areas (1990); the Regulation on the Implementation of the Land Administration Law of the People's Republic of China (amended in 2014); the Provision on Assignment of State-owned Construction Land Use Right through Bid Invitation, Auction and Quotation (2007), Regulation on the Administration of the Overall Planning of Land Usage (2017), Administrative Measures for the Preliminary Examination of Land Use for Construction Projects (revised in 2016) and Regulation on the Administration of Annual Planning of Land Usage (2016).

Use of land by enterprises and individuals is subject to the following maximum term limitations:

- 70 years for residential purposes;

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[697] Law on Land Contract in Rural Areas, Article 16

[698] Land readjustment can refer to comprehensive or 'large' readjustments where all farmland in the village is given back to the collective and reallocated again, so farmers are reallocated a different land. 'Small' or 'partial readjustments' mean adding or taking land from a household when the size of the household changed. Source: Ping Li, J.D. (2003) 'Rural land tenure reforms in China: issues, regulations and prospects for additional reform' Land Reform 2003/3, special edition. Retrieved from: http://www.landesa.org/wp-content/uploads/2011/01/LP-RuralLandTenureReforms.pdf (accessed on 10 October 2017)

- 50 years for industrial purposes;
- 50 years for the purpose of education, science, culture, public health and physical education;
- 40 years for commercial, tourist and recreational purposes; and
- 50 years for comprehensive use or other purposes[699]

The State may assign a land use right by means of an agreement, an invitation to bid or an auction with the exact procedure being decided at the provincial, autonomous region or municipality level.[700] There is a legal obligation to auction or bid the land used for commercial purposes. However, in certain circumstances granting of land-use rights can be done by means of a bilateral negotiation: '[For] *land used for commercial*, […] *purposes, where conditions permit, the means of auction or bidding shall be adopted; where conditions do not permit and it is impossible to adopt the means of auction or bidding, the means of agreement between the two parties may be adopted*'.[701] When the term of land use right expires, the holder of the land use right can apply for its renewal, subject to governmental approval.[702]

Land use rights can be 'granted' or 'allocated'. In both cases the decision on the transfer of land-use rights is made by local government bodies. As set out above, the *granted* land-use rights are restricted to a specific period of time and the transfer is subject to payment of granting fee.[703] Those rights are freely transferable in the secondary market.

By contrast, the *allocation* of land-use rights is limited to the following situations:
(1) Land used for state organs or military purposes;
(2) Land used for urban infrastructure or public utilities;
(3) Land used for projects of energy, communications or water conservancy, etc. which are selectively supported by the state; and
(4) Land used for other purposes as provided by laws or administrative rules and regulations.[704]

The allocated land-use rights may require payment of compensation or a resettlement fee, but can also be for free.[705] According to the above rules, certain entities could potentially be

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[699] Provisional Regulation of the People's Republic of China on Assigning and Transferring the Urban State-owned Land use Right (1990), Article 12.
[700] Ibid., Article 13.
[701] Law on Urban Real Estate Administration (2007), Article 12.
[702] Provisional Regulation of the People's Republic of China on Assigning and Transferring the Urban State-owned Land use Right (1990), Article 41.
[703] Law on Administration of Urban Real Estate (2007), Article 8.
[704] Ibid., Article 24
[705] Ibid., Article 23: '*Allocation of the land-use right refers to acts that the people's government at or above the county level, after the land user has paid compensation and expenses for resettlement, etc., approves in accordance with the law to allocate the land to the land user or gratuitously allocates the land-use right to the land user.*'

eligible to receive 'allocated' land use rights for free which obviously gives discretion to the authorities.

Whereas the rules concerning the transfer of granted land-use rights are relatively easy to comply with,[706] the granting land-use rights by an entity that originally received them through allocation is subject to a number of conditions, consisting in an examination and approval by the government, conclusion of the formalities necessary for granting of the land-use rights and payment of the granting fee.[707]

While land allocation is often not very transparent, it is also noted that some official documents favour land allocation to SOEs. An example is provided in the Opinions of the Ministry of Land and Resources on Further Control over Land Assets and Promotion of the Reform and Development of State-owned Enterprises[708] where it is provided that the State may allocate land to pillar SOEs in key industries as state investment.

The Ministry of Land and Resources ('MLR') adopted a more recent document, i.e. the Opinions of the Ministry of Land and Resources, the National Development and Reform Commission, the Ministry of Finance and Other Departments on Expanding the Scope of Paid Use of State-owned Land.[709] It did so with the aim of narrowing the scope of allocated land to SOEs. However, the preamble of these opinions explicitly notes:

> *Over recent years, China's economic development has entered a new normality and some problems are getting prominent, such as the fact that the surface coverage and system of the paid-use of public-owned land are not complete; in addition, the market does not yet fully play its decisive role as regards resource allocation.*

9.2.2. 13TH FYP ON LAND RESOURCES

The 13th FYP on Land Resources includes a number of provisions strictly controlling the allocation and prices of land use.

According to Chapter 3, Section 6 of this FYP, entitled '*Deepening the reform of land management*', China will introduce an 'experimental' allocation of industry land use, reduce the cost of land use and control land supply to certain sectors: '*foster the market allocation experiments for industry land use and effectively reduce the economic cost of land use;* […] *strictly control the land supply to steel, coal and other sectors in overcapacity as well as to "zombie enterprises"* […]'. Furthermore, the plan provides for improvements of the system

[706] Ibid., Article 39
[707] Ibid., Article 40
[708] Several Opinions of the Ministry of Land and Resources on Further Control over Land Assets and Promotion of the Reform and Development of State-owned Enterprises (MLR, effective Nov. 25, 1999).
[709] Opinions of the Ministry of Land and Resources, the National Development and Reform Commission, the Ministry of Finance and Other Departments on Expanding the Scope of Paid Use of State-owned Land, (No. 20 [2016] of the Ministry of Land and Resources).

of payable land use: '*further expand the scope of payable use of state-owned land, reduce transfers to non-public use and improve the management system applicable to transferred use of state-owned land.'*

Chapter 4, Section 13 provides for preferential land supply to a number of strategic industries: '*strengthen the coordination of land use with industry, further adjust the land use structure for industry land use, give priority to providing land for development purposes to emerging strategic industries and modern service business etc*.'

9.3. ACCESS TO ACQUIRING LAND-USE RIGHTS

The Outline of the Overall Planning of National Land Use (2006-2020)[710] sets out the planned areas for agricultural land and construction land in specific localities to be in place by 2020. Furthermore, the government controls the supply of land by setting a quota of the land area for which land-use rights can be sold for industrial or residential purposes, by province and by year.[711]

In principle, access to bidding for land-use rights destined for construction purposes should be open to all natural persons, legal persons and other organisations inside and outside of China.[712] However, it is common practice that only a number of bidders or participants (in case of auctions) are allowed to participate, instead of accepting all parties that registered.[713]

Furthermore, access to land can be encouraged or restricted in certain cases. For example, in the steel sector, the access to industrial land is by law limited only to companies respecting the industrial policies set by the State. Article 24 of the Order of the NDRC No.35 (Policies for Development of Iron and Steel Industry) sets out: '*For any project that fails to comply with the development policies for the iron and steel industry and has not been subject to examination and approval or where the examination and approval thereof fails to comply*

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[710] Ministry of Land and Resources, 全国土地利用总体规划纲要（2006－2020 年） http://www.mlr.gov.cn/xwdt/jrxw/200810/t20081024_111040.htm - (accessed on 23 August 2017).

[711] '*The government of the PRC also controls the supply of land, by restricting by quota the area of land for which land use rights can be sold for industrial or residential purposes, by province and by year*.' Statement of the PRC government in the proceedings of the TDI case: COMMISSION IMPLEMENTING REGULATION (EU) No 1379/2014 of 16 December 2014 imposing a definitive countervailing duty on imports of certain filament glass fibre products originating in the People's Republic of China and amending Council Implementing Regulation (EU) No 248/2011 imposing a definitive anti-dumping duty on imports of certain continuous filament glass fibre products originating in the People's Republic of China, para. 191.

[712] Provisions on the Assignment of State-owned Construction Land Use Right through Bid Invitation, Auction and Quotation (2007), Article 11: '*Unless it is otherwise prescribed by any law or regulation, all the natural persons, legal persons and other organizations inside and outside the territory of the People's Republic of China may apply for the participation in the assignment of state-owned construction land use right through bid invitation, auction or quotation*.'

[713] COMMISSION IMPLEMENTING REGULATION (EU) 2017/366 of 1 March 2017 imposing definitive countervailing duties on imports of crystalline silicon photovoltaic modules and key components (i.e. cells) originating in or consigned from the People's Republic of China following an expiry review pursuant to Article 18(2) of Regulation (EU) 2016/1037 of the European Parliament and of the Council and terminating the partial interim review investigation pursuant to Article 19(3) of Regulation (EU) 2016/1037, para. 426.

with the relevant provisions, the department of state land and resources shall not handle the formalities for land-use rights.'[714]

Article 12 of Decision No 40 of the State Council[715] (see Section 4.2.11) includes provisions on access to land based on the government investment policy: '*The "Guidance Catalogue for the Industrial Structure Adjustment" is the important basis for guiding investment directions, and for the governments to administer investment projects, to formulate and enforce policies on public finance, taxation, credit, land, import and export, etc.*' Article 18 of Decision No. 40 makes clear that industries that are 'restricted' will not have access to land use rights.[716]

9.4. LAND-USE RIGHTS PRICING

In principle, a system of auction should allow the market to judge the price of a particular land use right, and therefore the price should be set independently and correspond to the actual market value of the land-use right.

If the land-use right is granted via bilateral negotiations, the fee may not be lower than the minimum price fixed by the state's regulations.[717]

The authorities set the land-use right prices according to the Urban Land Evaluation System which instructs them among other criteria to consider also industrial policy when setting the price of industrial land.[718] Land is graded from 1 to 15 based on the quality of the land parcel and there are floor prices for each grade of land below which the price for the land use right cannot fall.[719]

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[714] 钢铁产业发展政策 第 35 号 (Development Policies for the Iron and Steel Industry, Order No. 35 of the NDRC, promulgated in 2005. Available at: http://www.gov.cn/flfg/2006-01/17/content_161597.htm (last accessed 10 October 2017)

[715] Decision of the State Council on Promulgating and Implementing the 'Temporary Provisions on Promoting Industrial Structure Adjustment' No. 40 [2005] of the State Council, 国务院关于发布实施《促进产业结构调整暂行规定》的决定, 国发〔2005〕40 号, available at: http://www.gov.cn/zwgk/2005-12/21/content_133214.htm

[716] '*The new investments project under the restricted category shall be prohibited.. The investment administrative department shall not examine, approve, ratify or archive the projects under the restricted category. No financial institution shall grant loans for such projects, and no administrative department of land administration, urban planning, construction, environmental protection, quality inspection, fire prevention, customs, or industry and commerce, etc. shall handle the relevant procedures for such projects.*', ibid. Article 18

[717] Law of the People's Republic of China on Management of Urban Real Estate – 2007, Article 13: '*Fees for granting the land-use right by means of agreement between the two parties shall not be lower than the lowest price determined in accordance with the regulations of the State.*'

[718] COUNCIL IMPLEMENTING REGULATION (EU) No 215/2013, of 11 March 2013, imposing a countervailing duty on imports of certain organic coated steel products originating in the People's Republic of China

[719] Statement of the PRC government in the proceedings of the TDI case: COMMISSION IMPLEMENTING REGULATION (EU) No 1379/2014 of 16 December 2014 imposing a definitive countervailing duty on imports of certain filament glass fibre products originating in the People's Republic of China and amending Council

MLR runs an urban land price dynamic monitoring system. Land prices are published on a quarterly basis for 105 Chinese cities. The findings of a trade defence instrument ('TDI') investigation confirmed that these prices are higher than the minimum benchmark prices set by the urban land evaluation system and used by local governments. This is because the benchmark prices set by the urban land evaluation system are updated only every three years, while the dynamic monitoring system updates prices quarterly. However, there was no indication that prices paid for the transfer of land use rights are based on the dynamic monitoring system. According to the government of China, the urban land price dynamic monitoring system is designed to assess the evolution of land prices and not serve as a benchmark for starting prices in biddings and auctions.[720] The considerable difference between the prices indicated by the dynamic monitoring system (which indicates the up-to-date prices) and the prices set by the urban land evaluation system shows that the minimum prices set by the State are below market value of the land-use-rights. Thus, any transactions that actually proceed on the basis of the minimum prices set by the State will likely be at less than market value.

A State Council notice from 2014, recognising that China might in in breach of its international legal obligations and in particular the WTO rules, introduced a prohibition on preferential land pricing:

> *It is necessary to focus on current situations, set clear priorities, resolutely abolish preferential policies that are in violation of laws and regulations to ensure that they are in line with the rules of the World Trade Organisation and China's commitments to the international community, and gradually standardise other preferential policies. [Article 2]*
>
> *The following activities are strictly prohibited: reducing, waiving or deferring the levy of administrative and institutional fees and government funds on enterprises, or transferring land parcels to enterprises at discounted prices or zero land price in violation of applicable provisions. [Article 3]*.[721]

However, a subsequent State Council notice issued in 2015 refers to the 2014 notice and indicates that it should be '*carried out subject to separate future arrangements*', thus effectively postponing this effort to prohibit preferential land pricing.[722]

Implementing Regulation (EU) No 248/2011 imposing a definitive anti-dumping duty on imports of certain continuous filament glass fibre products originating in the People's Republic of China, para. 190

[720] COMMISSION IMPLEMENTING REGULATION (EU) 2017/366 of 1 March 2017 imposing definitive countervailing duties on imports of crystalline silicon photovoltaic modules and key components (i.e. cells) originating in or consigned from the People's Republic of China following an expiry review pursuant to Article 18(2) of Regulation (EU) 2016/1037 of the European Parliament and of the Council and terminating the partial interim review investigation pursuant to Article 19(3) of Regulation (EU) 2016/1037, paras 424-425.

[721] State Council Notice on cleaning up and standardising tax and other preferential policies State Council Legal Affairs Office 2014/62.

[722] See *State Council Notice on Issues concerning Taxation and Other Preferential Policies* (2015)

9.4.1. PREFERENTIAL PROVISION OF LAND TO SPECIFIC INDUSTRIES

The fourth pillar of SSSR, '*Lowering corporate costs*', includes also provisions on lowering the cost of land. As a practical consequence of this policy some provinces introduced preferential rules on granting land for specific industries. For example in Guangdong province: *'[a]s regards Guangdong's industries to be developed in priority as well as land-use-intensive manufacturing industries, the reduced price of land transfer can amount to 70% of the lowest standard price of land for industrial use, depending on where the piece of land is located*.'[723] The Shaanxi implementation of SSSR provides for a similar clause: *'[a]s regards the land used by industry projects complying with the Shaanxi Province industry orientations concerning strategic emerging industries, advanced manufacturing industries and IT economy industry, the minimum price of land used for industry purposes may be applied*'.[724]

There are also provisions in place providing for favourable access land for foreign investors, as long as they comply with the State planning policies:

> *All regions shall be allowed to give priority to guaranteeing the construction land use quotas needed by the foreign investment projects in national-level development zones under the premise of compliance with economic and social development planning, overall land-use planning and overall urban planning, so that all such quotas that shall be made available are made available.*[725]

9.5. RURAL LAND

Agricultural land tenure is based on a household contract system. Farmland is owned by the village collectives, which extend contracts to individual households – the duration of such contract is in principle for 30 years[726] and the permitted uses include crop cultivation, forestry, animal husbandry or fishery.[727]

Non-agricultural uses are prohibited in rural areas unless there is a governmental approval. Furthermore, collectively owned land cannot be transferred on the market as only State owned urban land can be leased for non-agricultural land use. Collectively owned land within a designated urban area has to be converted to State owned land before the land-use rights can

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[723] Source Guangdong People's Government Notice: 广东省人民政府关于印发广东省降低制造业企业成本支持实体经济发展若干政策措施的通知 粤府〔2017〕90 号 http://www.gdczt.gov.cn/zwgk/czxw/201708/t20170825_884703.htm

[724] See Article 28, Shaanxi People's Government Notice as to preparing an action plan for supply-side structural reforms and cost reduction, Shaanxi Government 2016/38, Date 22 Sept 2016

[725] See Article 3.10 of the Notice of the State Council on Several Measures for Promoting the Growth of Foreign Investment, Guo Fa [2017] No. 39, 国务院关于促进外资增长若干措施的通知, 国发〔2017〕39 号, available at: http://www.gov.cn/zhengce/content/2017-08/16/content_5218057.htm

[726] Property Rights of the People's Republic of China (2007), Article 126: '*The contracted term of farmland shall the 30 years, 30 to 50 years for grassland and 30-70 years for forestland*'.

[727] Land Administration Law of the People's Republic of China (1986, amended 2004) Article 14.

be sold.[728] Therefore, subnational governments need to expropriate collective rural land and convert it into urban land to be able to sell the land-use rights on the market. Sales of land-use rights to private developers and businesses constitute a large proportion of local governments' income. In 2013, land revenue (including land-use rights transfer fees, property-related taxes, etc.) accounted for 87.5% of local government's total income, and 61% of local government revenue could be attributed to the land-use rights transfer fees.[729]

The government has the right to expropriate the land from the farmers: '*[t]he State may, in the interest of the public, lawfully expropriate or requisition land and give compensation accordingly*'.[730] The largest part of the compensation, the land compensation fee, is set at 6-10 times the average annual agricultural output value of the expropriated land,[731] which in many cases is far below the market value that the private developers are willing to pay for the plot. The 'interest of the public' is not further defined in the law and the compensation has reportedly been minimal in many cases, leading at times to land grabs and forced evictions causing social unrest in China. For example the majority of 'mass incidents' that occurred in China in the early 2000s were due to land disputes with the local governments.[732] According to some estimates 6-7 million hectares of farmland were expropriated for urban or commercial use, and 50-60 million rural residents were affected by land expropriation. A large proportion of farmers were not receiving any compensation and the rest receiving just a small percentage (2.5%) of the market value of the land.[733]

The restrictions in land-use rights and the impossibility to sell them led to the development of 'minor property rights'. This term is used to describe situations when the rural land-use owner sells his land-use rights to private developers, even though formally this is not legal, or constructs buildings on their land in order to rent out units (doing this on his own or in conjunction with a private developer).[734] Sale of rural land-use rights or construction of rental property violates the restriction on the use of rural land for exclusively agricultural purposes. Therefore, there is no security of contract in case of rental and the sales agreements are also legally void. The buyers of those rights risk that at any moment the land might be taken away from them or the buildings demolished. However, it seems that the economic incentive of revenues from rental still outweighs the legal risks, as there are a large number of such semi-legal transfers of land-use rights. According to some estimates, this type of housing is increasingly common especially around major cities such as Beijing, Shanghai and Shenzhen

[728] Urban Real Estate Administration Law of the People's Republic of China (1994, amended 2007), Article 9.
[729] See MLR website, 土地出让金占地方财政半壁江山 金融风险不容小觑, available at: http://www.mlr.gov.cn/xwdt/jrxw/201509/t20150902_1365555.htm
[730] Land Administration Law of the People's Republic of China (1984 amended 2004), Article 2.
[731] Ibid., Article 47.
[732] Wong, V. (2014). *Land Policy Reform in China: Dealing with Forced Expropriation and the Dual Land Tenure System*, Centre for Comparative and Public Law Faculty of Law The University of Hong Kong, , Occasional Paper No. 25, May, page 3
[733] Ibid.
[734] Ibid., page 41.

with the total area in China of 6.6 billion square meters, 18% of housing around Beijing, and even up to half of all housing around some of the larger cities in China.[735]

All this shows that the Chinese land allocation system is still in flux.

9.6. FINDINGS IN PREVIOUS TDI CASES

Even though as described above there are rules governing the transfer of land-use rights for commercial purposes, which in principle should ensure impartiality and equal opportunities for different economic players, those rules are in practice often not applied. In previous TDI investigations of the European Commission a number of distortions were found.

Firstly, some SOEs received the land land-use rights for free.[736] Free provision of land to enterprises in order to attract investment is also confirmed by independent sources.[737] In a former TDI investigation the Commission also found a case where the enterprises paid for the land-use right, but those fees were subsequently refunded by the local authorities.[738]

Secondly, in a number of cases it was questionable whether an auction actually took place, as the only participant was the company who was granted the contract at the auction starting price. In one case the Commission was also not able to find any proof of an actual auction taking place including the procedural step of publishing the formal public notice.[739] In the instances where the Commission was able to find public bid notices, there were considerable discrepancies with the legal requirements as set out in the law:

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[735] Ibid., page 3, p. 43.

[736] See for example: Commission Implementing Regulation (EU) 2017/969 of 8 June 2017 imposing definitive countervailing duties on imports of certain hot-rolled flat products of iron, non-alloy or other alloy steel originating in the People's Republic of China and amending Commission Implementing Regulation (EU) 2017/649 imposing a definitive anti-dumping duty on imports of certain hot-rolled flat products of iron, non-alloy or other alloy steel originating in the People's Republic of China, para. 287;

[737] Ahuja, A., Chalk, N.A., Porter, N., N'Diaye, P. and Nabar, M. (2012). *An End to China's Imbalances?* IMF Working Papers, Working Paper No. 12/100.

[738] '*It was also found that some sampled exporting producers received refunds from local authorities to compensate for the (already low) prices which they paid for the LURs*.' COUNCIL IMPLEMENTING REGULATION (EU) No 1239/2013 of 2 December 2013 imposing a definitive countervailing duty on imports of crystalline silicon photovoltaic modules and key components (i.e. cells) originating in or consigned from the People's Republic of China, para 365.

[739] COUNCIL IMPLEMENTING REGULATION (EU) No 1239/2013 of 2 December 2013 imposing a definitive countervailing duty on imports of crystalline silicon photovoltaic modules and key components (i.e. cells) originating in or consigned from the People's Republic of China, para. 357: *'During the verification the Commission requested from the government evidence to support its claims concerning the transfers of LUR in China is assigned through bidding, quotation or auction. It is noted that according to Article 11 of Provisions on Assignment of the State-owned Construction Land Use Right through Bid Invitation, Auction and Quotation the responsible state authority issues public notice whenever the bidding/auction/quotation process takes place. On this basis, the Commission requested all public notices for the transactions which were subject to these procedures in order to collect and verify information requested in the questionnaire. The government did not provide any of these notices as it claimed that 'they do not exist anymore'.*

> *During the verification of sampled exporting producers, the Commission obtained some notices issued by relevant authorities concerning LUR [*land use rights*] available for transfer. While one notice specifically limits the potential buyers of the LUR to the photovoltaic industry, another sets limits to the price initially set by the authorities and does not allow the market to determine the price. The auctions themselves were not seen to provide a real competition because in many of the examples viewed during the on spot verifications of exporting producers only one company made a bid (only the sampled PV producer) and therefore their opening bid (the value set by the local Land Bureau) formed the final price per square metre.*[740]

The TDI investigation on certain filament glass fibre products found that: '[…], *for each and every land use right purchase by the sampled exporting producers, the Commission found no evidence of an auction process that independently set the price of the land use right. The exporting producer* […] *was the only bidder, [and] was awarded the land use right*'.[741]

Lack of bidding process and arbitrary initial price setting was also found in a TDI investigation on certain steel products.[742]

In another case the Commission found similar types of distortion, with the findings of distortions being further supported by the statements of the involved companies:

> […] *for each and every land use right purchase by the sampled exporting producers, the Commission found no evidence of an auction process that independently set the price of the land use right. The company awarded the land either bid the starting price, or 5 CNY per square metre more than the starting price, and, as it was the only bidder, it was awarded the land use right.*
>
> […] *The government then stated that the floor prices are there to ensure that the final price does not fall below 'the basic market value' for the land use right. No evidence was provided to support this statement, which is in itself circular, as the amount of money paid for the land use right (which the government has fixed) is supposed to be the market price (on which the floor is then based).* […]

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[740] COUNCIL IMPLEMENTING REGULATION (EU) No 1239/2013 of 2 December 2013 imposing a definitive countervailing duty on imports of crystalline silicon photovoltaic modules and key components (i.e. cells) originating in or consigned from the People's Republic of China, para 364.
[741] COMMISSION IMPLEMENTING REGULATION (EU) No 1379/2014 of 16 December 2014 imposing a definitive countervailing duty on imports of certain filament glass fibre products originating in the People's Republic of China and amending Council Implementing Regulation (EU) No 248/2011 imposing a definitive anti-dumping duty on imports of certain continuous filament glass fibre products originating in the People's Republic of China, para. 192.
[742] COUNCIL IMPLEMENTING REGULATION (EU) No 215/2013, of 11 March 2013 imposing a countervailing duty on imports of certain organic coated steel products originating in the People's Republic of China, paras 112-117.

> *The government, despite requests, has not provided evidence of one single land use right being priced by competitive auction, and therefore the effect of the process is that the government sets the price and the company pays this price. While multiple bidders may not be an absolute requirement in every instance in order to establish the existence of a market-based system, the complete lack of multiple bidders, which was found to be the case with regard to all sampled companies, is a strong indication of the absence of true market prices.* […]
>
> […] *In the case where one sampled company paid 5 CNY per square metre more than the price set by the government, the company stated to the Commission that they were told to do so by the competent authority simply to make it look as if an auction had taken place.*[743]

Another type of distortion concerns land-use right valuation. In a previous TDI investigation it was found that the price paid for the land-use right was below market value:

> […] *a property valuation report established by an independent auditor.* […] *shows that there is marked difference between the price paid by the exporting producer for its land use right and the market value.*
>
> *Concerning the valuation of the land-use rights, the Commission disclosed to the interested party the detailed methodology used to estimate the difference between the fair market value and the actual costs.* […] *The difference of + 35 % was found significant and can be only explained by a transfer price well under a fair market value at the time of the transaction between the company and the local authorities.*[744]

In certain instances the Commission also found that the land-use rights were traded at a market value price.[745] Nevertheless, a number of previous European Commission TDI investigations established distortions with regard to the land-use rights. Other authorities investigating the situation in China also found distortions with regard to preferential supply of land.[746] Therefore it seems that the implementation of the law varies from case to case, with a majority of investigated cases however finding considerable distortions.

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[743] COMMISSION IMPLEMENTING REGULATION (EU) No 471/2014 of 13 May 2014 imposing definitive countervailing duties on imports of solar glass originating in the People's Republic of China, paras 176-181.
[744] COMMISSION IMPLEMENTING REGULATION (EU) 2016/1247 of 28 July 2016 Imposing a definitive anti-dumping duty and collecting definitively the provisional duty imposed on imports of aspartame originating in the People's Republic of China, paras 24 and 56.
[745] See for example COMMISSION IMPLEMENTING DECISION (EU) 2016/176 of 9 February 2016 terminating the anti-dumping proceeding concerning imports of tartaric acid originating in the People's Republic of China and produced by Hangzhou Bioking Biochemical Engineering Co. Ltd, para. 60
[746] See for example Canada Border Services Agency, Statement of Reasons Concerning the making of final determinations with respect to the dumping and subsidizing of certain stainless steel sinks originating in or exported from the People's Republic of China. Decision in case number AD/1392 and CV/129. http://www.cbsa-asfc.gc.ca/sima-lmsi/i-e/ad1392/ad1392-i11-fd-eng.html

9.7. CHAPTER SUMMARY

The system of land property and land-use rights is still under development. Even though there are certain legal provisions on land-use rights transfer and pricing, those are often not implemented in practice, as shown in former TDI investigations of the European Commission: a number of buyers (in particular SOEs) received their land for free or participated in fictitious tenders with only one participant, obtaining the land use rights at a very low price. There are also significant discrepancies between different regions and individual cases. A number of distortions were established at the level of implementation: the rules on land provision and acquisition in the PRC are often unclear and non-transparent, and the prices are often set by the authorities on the basis of non-market considerations.

However, the issues with land allocation in China go much beyond the insufficient enforcement of existing laws. One problem is the fact that all land is owned by the State (collectively owned rural land and state-owned urban land), therefore the allocation of land is solely dependent on the state, which may pursue specific political goals rather than free market principles. Indeed, there is evidence of direct intervention by the State in the allocation of land (or of use rights): for example there are rules that prevent the allocation of land for investments in sectors in which overcapacities exist (see Chapter 3, Section 6 of the 13th FYP on Land Resources entitled '*Deepening the reform of land management*'). Another example is provided by the same document which also stipulates that priority shall be given to providing land for development purposes to emerging strategic industries and modern service businesses (see Chapter 4, Section 13 of the 13th FYP on Land Resources).

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10.1. INTRODUCTION

10.1.1. ENERGY MARKET OVERVIEW

China is currently the world's largest electricity producer with a total installed generation capacity (data for 2016) of some 1650 GW, of which coal-fired capacity accounts for 946 GW (57%), hydro for 332 GW (20%), gas for 70 GW (4%), nuclear for 34 GW (2%) and wind together with solar for 223 GW (13%)[747] and a total generation of 5 990 TWh, of which 3 906 TWh is by coal-fired power plants (65%), 1181 TWh by hydro (20%), 188 TWh by gas (3%), 213 TWh by nuclear (4%), 241 TWh by wind (4%) and 66 TwH by solar (1%).[748]

[747] See China Electricity Council, (2017). *China Power Industry Development Report*, available at: http://www.cec.org.cn/guihuayutongji/gongzuodongtai/2017-09-11/172982.html

[748] See China Electricity Council website: http://www.cec.org.cn/guihuayutongji/tongjxinxi/niandushuju/2017-01-20/164007.html (accessed on 15 November 2017). In 2006 China introduced the Law for Renewable Energy, and since then the production of renewable energy (wind and solar) has risen from 2.07 GW in 2006 to 172.93 GW in 2015 (Data for 2015 according to China Statistical Yearbook 2016, National Bureau of Statistics of China).

Together with economic growth, the growth in electricity consumption in China in recent years was very rapid, more than quadrupling between 2000 and today.[749] The growth rate of 5% in 2016 is slower than in the past decade, but still much larger than in the EU or USA. At the same time, electricity capacity rose even faster with a growth rate of over 9% in 2016, leading to a large structural overcapacity. The government also set a goal to reduce the share of coal to 62% of total energy consumption by 2020,[750] and this target percentage for 2020 was further reduced in 2016 – see below. However, while the energy market in China has undergone a number of changes and reforms,[751] some prices relevant for the energy system are still not market based. The government recognises that the prices are still largely controlled by the state: '*The current electricity price management is still based on government prices. Price adjustments often lag behind changes in costs and it is difficult to timely and reasonably reflect the electricity usage costs*[…]'. [752] Given that in certain industries electricity is a very important or even the main production cost input, (market based) electricity pricing represents an essential question of the energy sector. As an example, the share of electricity costs in China in the final production cost is as follows: aluminium smelters: around 40%,[753] silicon metals: 55-60%.[754]

Furthermore, the electricity market in China is characterised by strong involvement of SOEs in various stages of the supply chain. Around 50% of the generation capacity is state owned,[755] whereas the entire transmission grid is owned by two SOEs: State Grid Corporation of China and China Southern Power Grid. The government recognizes the problem of the lack of sufficient competition: *'an effective competitive mechanism for the sale of electricity has not yet been established, market transactions between electricity generation enterprises and*

[749] IEA. (2016). World Energy Outlook 2016, p. 274.
[750] Denjean, B., Su, T., Attwood, C., Bridle, R., Duan, H. and Gerasimchuk, I. (2016). *Subsidies to Coal Power Generation in China*. Geneva: GSI. Retrieved from https://www.iisd.org/sites/default/files/publications/subsidies-coal-power-generation-china.pdf.
[751] For instance, reforms in 2002 detached the power generation from transmission and distribution networks and the two are now operated by separate entities.
[752] *Opinions Regarding the Deepening of the Power Sector's Reform* issued in March 2015 by the CPC Central Committee and the State Council (关于进一步深化电力体制改革的若干意见).
[753] Yam, P. (2015). *China aluminium smelters seek power fee cuts as metal price hits lows*, Reuters http://www.reuters.com/article/china-aluminium-power-idUSL3N13138W20151106 (accessed on 23 August 2017)
[754] Statement of Reasons concerning the making of final determinations with respect to the dumping and subsidizing of Certain Silicon Metal originating in or exported from the People's Republic of China. Dumping case number: AD/1400, Subsidy case number: CV/136, Ottawa, November 5, 2013.
[755] Latest official data shows that the largest five power generators electricity generation accounted for 45.5% (Huaneng, Huadian, Guodian, Datang and State Power Investment). In addition, to the other state-owned power generators, such as China Yangtze Power Co. Ltd and CGN, the figure will probably exceed 50%. Source: http://www.wusuobuneng.cn/archives/22266 (accessed on 25 August 2017). According to the data for 2015 of the China Statistical Yearbook 2016, National Bureau of Statistics of China, 97% of the aggregated production and supply of electric power and hear power is state owned (97% by assets and 83% in terms of number of enterprises).

users are limited and it is difficult to involve the decisive role of the market in the allocation of resources'.[756]

It is worth noting that the strong state presence does not only concern the electricity market but extends to the entire energy sector which is apparent from the fact that out of 102 centrally owned SOEs currently being overseen by SASAC, 21 are in the energy sector: China National Nuclear Corporation, China Nuclear E&C Group, China National Petroleum Corporation (CNPC), SINOPEC, China National Offshore Oil Corporation (CNOOC),[757] State Grid Corporation of China, China Southern Power Grid, China Huaneng Group, China Datang Corporation, China Huading Corporation, China Guodian Corporation, State Power Investment Corporation,[758] Shenhua Group,[759] China Energy Conservation and Environment Protection Group, China National Coal Group Corp, CCTEG, China National Administration of Coal Geology, Power Construction Corporation of China, China Energy Engineering Corporation Limited, China General Nuclear Power Corporation and China XD Group.

10.1.2. PLANS

The targets for energy and electricity development are set out in a number of documents, including the Energy Development Strategy Action Plan (2014-2020) as well as the central 13th FYP and the following FYPs: Shale Gas Development Plan, Natural Gas Development Plan, Oil Development Plan, Renewable Energy Development Plan, Solar Energy Development Plan, Electric Power Development Plan, Wind Power Development Plan, Energy Technology Innovation Plan, Coal Industry Development Plan, Geothermal Energy Exploration and Usage Plan, Energy Conservation and Environmental Protection Industry Development Plan, Biomass Energy Development Plan and Rural Biogas Development Plan.

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[756] Opinions Regarding the Deepening of the Power Sector's Reform issued in March 2015 by the CPC Central Committee and the State Council (关于进一步深化电力体制改革的若干意见).

[757] CNPC controls about 70% of all natural-gas production and sales in China, Sinopec and CNOOC handle 16% and 10%, respectively (in total, 96%). See: www.caixinglobal.com/2017-05-21/101093121.html

[758] According to some sources (see Hornby, L. (2017). *China's consolidation push turns to sprawling power sector*: Financial Times https://www.ft.com/content/50614ed4-4c69-11e7-919a-1e14ce4af89b, accessed on 16 June 2017), the five electricity generators China Huaneng Group, China Datang Corporation, China Huading Corporation, China Guodian Corporation, State Power Investment Corporation have been earmarked by the government for mergers with coal mining groups and nuclear power groups. The move should help optimise capacity and resolve tensions between state-owned coal miners and state-owned coal-fired power generators. Such industry consolidation leading to creation of national champions is known from other sectors in China (see Chapter 5).

[759] In the coal sector, Shenhua Group is China's (and the world's) largest producer with an annual output of over 300 million tonnes (see *China's efforts to phase out and rationalise its inefficient fossil-fuel subsidies*. A report on the G20 peer review of inefficient fossil-fuel subsidies that encourage wasteful consumption in China. 5 September 2016) accounting for about 50% of country's coal (see U.S. Energy Information Administration, (2015). *China: International Energy Data and Analysis* (Washington, DC: May 14, 2015), https://www.eia.gov/beta/international/analysis.cfm?iso=CHN). Local state-owned companies produce about 20% and small town mines the remaining 30% of China's coal output (see U.S. Energy Information Administration, (2015). *China: International Energy Data and Analysis* (Washington, DC: May 14, 2015), https://www.eia.gov/beta/international/analysis.cfm?iso=CHN).

The Energy Development Strategy Action Plan, issued in 2014 by the State Council, covers the period between 2014 and 2020 and sets out a number of detailed targets with regard to energy production and consumption in China. The plan stipulates that energy self-sufficiency should be maintained at around 85%. Furthermore, it sets targets for installed capacity of hydro, wind and solar power (they should reach 350GW, 200GW and 100GW respectively) and the share of non-fossil fuel should rise to 15% by 2020 The plan furthermore limits the annual coal consumption to 4.2 billion tonnes by 2020.

The comprehensive 13th FYP on Electricity Development, published in November 2016, covers all types of energy sources in China: hydro-power, nuclear power, coal-fired power generation, gas-fired power generation, wind power, solar power etc. and all sorts of electricity and energy as well as the power distribution network. The Plan outlines the governmental policies with respect to different energy aspects, including the energy reform with the goal to: '*deepen the institutional reforms in the electrical sector, improve the electricity market system'*. The plan provides for price control with regard to transport and distribution: *'*[…] *before the end of 2017, complete the establishment of voltage classes and examine and establish the electricity grid enterprises' authorized total income as well as the electricity transport and distribution prices* […]'. Moreover, it sets out the goal of further price liberalisation: '*Orderly liberalise network electricity prices as well as prices for electricity that is not used for public interests purposes*'.[760] The government will remain strongly involved into further shaping of the energy market, including investment: '*actively guide private capital investments'*.[761]

The 13th FYP on Energy Development, published in December 2016 outlines goals and the future direction of the energy policy in China. The plan sets out a number of detailed 2020 targets, including a limitation of coal in primary energy consumption to 58%, whereas the non-fossil fuels should constitute at least 15% of primary energy consumption. The target for installed capacity for wind energy is set at more than 210GW, for solar energy at more than 110GW, and the target for coal energy installed capacity is capped at no more than 1 100GW. The targets in this plan are somewhat more ambitious than the targets set out in the Strategic Energy Action Plan issued in 2014.

10.1.3. REGULATORY AGENCIES

The issues pertaining to energy are mostly managed by the National Energy Administration ('NEA'), which was established in 2008, within the framework of the NDRC. The State Electricity Regulatory Commission was merged into NEA in 2013, substantially strengthening its role and responsibilities.[762] The functions of NEA include formulating and implementing energy development plans and industrial policies, promoting institutional

[760] See 13th FYP on Electricity Development, Section IV-7.
[761] See Ibid., Section IV-7.
[762] Standing Group for Global Energy Dialogue, (2015). *China's energy sector reform*, International Energy Agency, 23-24 September 2015.

reform in the energy sector, and administering energy sectors including coal, oil, natural gas, power (including nuclear power), new and renewable energy etc.[763] Furthermore, a number of other authorities have certain competencies with regard to the energy sector, including SASAC (see Chapter 5 concerning the role of SASAC with respect to SOEs), the Ministry of Environmental Protection, MOFCOM, MLR, the State administration of Work Safety and General Administration of Quality Supervision, Inspection and Quarantine, and the State Oceanic Administration Offshore regulator.[764]

Energy pricing remains with the NDRC Department of Price,[765] and the Bureau of Economic Operation Regulation of the NDRC is responsible for coordinating the operation of the coal, oil and gas, power and transportation markets.[766]

10.2. DESCRIPTION OF COST-RELATED FACTORS IN THE CHINESE ENERGY MARKET

10.2.1. PRICING

10.2.1.1. CENTRAL PRICE-SETTING

The Department of Price in NDRC is responsible for overseeing prices in China, including the price setting in case of items included in the Catalogue of Pricing by the central government. According to the Catalogue, only items included therein are 'subject to government-fixed price and government-guided price'. All other items are 'subject to market-regulated price'.

The prices for electricity and domestic natural gas are regulated by NDRC[767] and according to the Chinese government set on the basis of a procedure that includes cost investigation, expert appraisal, public hearings, and final price determination and publication.[768] The NDRC publishes the prices applicable to each province in Notices, and then the local price bureaus publish a corresponding notice at the local level implementing the prices decided by the central NDRC. The prices are set at the power plant or generating-equipment level.[769] The final price is supposed to reflect purchasing costs, transmission costs and losses, and government surcharges. However it seems that on top of this 'cost plus' approach, the prices

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[763] National Energy Administration's website: http://en.ndrc.gov.cn/mfod/200812/t20081218_252224.html
[764] Standing Group for Global Energy Dialogue, (2015). *China's energy sector reform*, International Energy Agency, 23-24 September 2015.
[765] See *Notice of State Council on Reform of Electricity Price (2003), Art. 33 (*国务院办公厅关于印发电价改革方案的通知).
[766] Standing Group for Global Energy Dialogue, (2015). *China's energy sector reform*, International Energy Agency, 23-24 September 2015.
[767] Whereas the prices of oil, coal and pipeline-imported natural gas have been to some extent liberalised and are no more centrally regulated (see Section 12.5.1).
[768] Council Implementing Regulation (EU) No 215/2013 of 11 March 2013, imposing a countervailing duty on imports of certain organic coated steel products originating in the People's Republic of China. The legal basis for electricity price setting is the Electric Power Law from 1995, revised in 2015.
[769] G20. (2016). *China's efforts to phase out and rationalise its inefficient fossil-fuel subsidies. A report on the G20 peer review of inefficient fossil-fuel subsidies that encourage wasteful consumption in China.* (5 September 2016). Available at: https://www.oecd.org/site/tadffss/publication/G20%20China%20Peer%20Review_G20_FFS_Review_final_of_20160902.pdf

are further differentiated by province depending on the local situation and policy objectives pursued in the various provinces,[770] as well as by customer category.

10.2.1.2. PRICE DIFFERENTIATION

The differentiation by customer category does not only follow the line of residential vs. industrial customers,[771] but also extends to differentiation between customers using modern energy-saving technologies vs. customers using outdated energy-intense machinery. In this respect, three-tiered electricity pricing is applied by the government to phase out outdated production and promote industrial restructuring more quickly.[772] Three-tiered pricing applies to a number of industries[773] and represents an efficient tool in pursuing the industrial policies reflected in the catalogue contained in Decision No. 40 (See Section 4.2.11). Users falling in the 'encouraged' sectors according to the NDRC catalogue pay the basic electricity rate, whereas users falling in the 'outdated' or 'prohibited' sectors pay a surcharge on top of the basic rate. Users not falling into any category listed in the catalogue fall in the default category of 'allowed' enterprises and also pay the basic rate without surcharges.

In parallel to the differentiation described above, it was established in a number of instances that selected industries receive at the provincial level special electricity tariffs which are lower than electricity tariffs paid by other industrial users. Such practice was found for instance in 2013 by the Canada Border Services Agency ('CBSA') with regard to silicon metal. CBSA found that the government exercises substantial influence over key raw material inputs in the silicon metal industry, including electricity and coal which together account for as much as 70% of the cost of production.[774] The Canadian industry demonstrated that silicon metal producers in Yunnan province benefitted from electricity prices considerably lower than producers in other provinces (32% lower according to the complainant in the case) and the

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[770] Council Implementing Regulation (EU) No 215/2013 of 11 March 2013, imposing a countervailing duty on imports of certain organic coated steel products originating in the People's Republic of China.

[771] Retail electricity prices are regularly adjusted at provincial level (see G20. (2016). *China's efforts to phase out and rationalise its inefficient fossil-fuel subsidies. A report on the G20 peer review of inefficient fossil-fuel subsidies that encourage wasteful consumption in China.*).

[772] Zhang, Z.X. (2014). *Energy prices, subsidies and resource tax reform in China*, Asia and the Pacific Policy Studies, 1(3): 439–454.

[773] For example, according to a rule introduced by the NDRC in December 2013, as from the beginning of 2014, power tariffs were to remain unchanged for aluminium smelters using less than 13 700 kWh per tonne of electrolytic aluminium. Smelters using between 13 700 kWh and 13 800 kWh get an additional surcharge of RMB 0.02 per kWh and smelters using above 13 800 kWh per tonne pay a surcharge of RMB 0.08 per kWh. Moreover, smelters consuming more than 13,700 kWh per tonne or whose energy saving target assessment is not completed, are not allowed to purchase electricity directly from the power plants (see NDRC MIIT, *Notice on the implementation of a multiple-tier-pricing of electricity used by electrolytic aluminium enterprises*, NDRC 2013/2530, 13 December 2013, Article I.i). The differential pricing for aluminium is also included in the 13th FYP for nonferrous metals: *'[China shall:] -implement an electrical power price policy, with various price levels, for the electrolytic aluminium sector, […]*' (see 13th FYP for nonferrous metals, V/4).

[774] Statement of Reasons concerning the making of final determinations with respect to the dumping and subsidizing of Certain Silicon Metal originating in or exported from the People's Republic of China. Dumping case number: AD/1400, Subsidy case number: CV/136, Ottawa, November 5, 2013.

CBSA investigation confirmed that the prices paid by the silicon metal producers were lower from those paid by other heavy industries in Dehong Prefecture in Yunnan.[775]

In an Australian investigation into silicon metal in 2015, the Australian Government Anti-Dumping Commission found that the industries in the silicon manufacture sector benefitted from preferential electricity rates and paid lower electricity fees than other heavy industries in Yunnan province.[776]

A similar procedure was found in an investigation on organic coated steel products conducted by the European Commission in 2013.[777] The investigation established that differential electricity rates are set in accordance with certain factors, including the pursuit of industrial policy goals. The investigation furthermore confirmed that a particular organic coated steel producer benefited from an electricity rate lower than the rate generally applicable for large industrial users, because it belonged to a category of industrial users entitled to a lower electricity rate.

Certain aluminium producers also paid lower electricity rates as from 2015 (when metal prices experienced an important drop). For example, a state owned Liancheng smelter in Gansu province was awarded an electricity price cut, from 0.375 RMB to 0.25 RMB per kWh.[778] At the end of May 2016, the Yunnan Province Government published a document stating that in order to promote the quick development of hydro-electrical aluminium production it would further reduce the cost of electricity used by enterprises. This guaranteed Yunnan Aluminium Corporation, the main electricity consumer in the province, a price not exceeding 0.2785 RMB per kWh from June 2016 to May 2017. This effectively granted a power tariff cut of 20% compared to 2015.[779]

Some provinces furthermore offer cheaper electricity rates to other specific industries. For example, the two traditionally industrial provinces of Chongqing and Zhejiang offer lower rates for the manufacturing of electric furnace iron alloy, electrolytic caustic soda, synthetic ammonia, electric furnace calcium magnesium phosphate, electric furnace yellow phosphorus

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[775] Statement of Reasons concerning the making of final determinations with respect to the dumping and subsidizing of Certain Silicon Metal originating in or exported from the People's Republic of China. Dumping case number: AD/1400, Subsidy case number: CV/136, Ottawa, November 5, 2013.
[776] Customs Act 1901 – Part XVB, Report No. 237, Alleged Dumping of silicon metal exported from the People's Republic of China and alleged subsidisation of silicon metal exported from the People's Republic of China. 7 May 2015.
[777] Council Implementing Regulation (EU) No 215/2013 of 11 March 2013 imposing a countervailing duty on imports of certain organic coated steel products originating in the People's Republic of China.
[778] Yam, P. (2015). *China aluminium smelters seek power fee cuts as metal price hits lows*, Reuters http://www.reuters.com/article/china-aluminium-power-idUSL3N13138W20151106 (accessed on 23 August 2017).
[779] Xinhua, (2016). 云南电力供需失衡利益博弈激烈 电价改革箭在弦上 http://news.xinhuanet.com/finance/2016-06/27/c_129091991.htm (accessed on 23 August 2017).

and calcium carbide, and electrolytic aluminium (in Chongqing), as well as electrolytic aluminium and chloralkali production in the case of Zhejiang.[780]

There are also a number of economic zones granting preferential prices and subsidies to companies located in the zone. For example, in the Shawan Industrial Park in Xinjiang, 'preferential policies for electrical power supply, water supply etc. [are] granted by the park.' According to the official website of the Tacheng District where it is located, the '*enterprises benefit from many preferential policies, for instance electricity power price subsidies'*.[781]

As from 2015, Xinjiang also introduced preferential electricity pricing to the textile and garment manufacturing industry. This was applicable in the whole province. Those price cuts resulted in an annual reduction of electricity power costs for textile enterprises of more than RMB 100 million.[782] According to a press article on the subject, the subsidies for the textile industries in the entire Xinjiang province were suspended as from August 2016. However, the subsidies are still provided to the textile companies located in the industrial zone of the Tacheng District and a new programme of '*specific subsidies*' for the textile and garment industry was introduced.[783]

Preferential electricity prices are also provided to enterprises located in the Wuyi New District in Fujian province: '*the electricity price for large industries is RMB 0.5232 per kWh and the electricity price for non-general industry is RMB 0.5862 per kWh. This is RMB 0.0872 per kWh less than the price of the electricity direct supply from the province's grid.* […] *Industrial enterprises located in the Park are exempt from electricity power survey fee, budget fee and design fee, which equals to a reduction of 30% compared to the national standard amounts*'.[784] Irrespective of the level of the national standards referred to, the price decrease of RMB 0.0872 per kWh amounts to an electricity price for large industries which is 14% lower than the default provincial rate.

China recognises that the practices offering preferential electricity rate to specific industries in individual provinces '*may breach China's international commitments'*, including WTO

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[780] Chongqing Price Bureau: http://www.cqpn.gov.cn/njgzc/55730.htm (accessed 20 June 2017), Zhejiang Price Bureau: http://www.zjpi.gov.cn/WebSite/XinXiCk?xxid=49ff94b403d54567b51b1f3130c31f36 (accessed 20 June 2017).

[781] *Shawan industrial park is duly planning help to the development of enterprises*, Source: Xinjiang Tacheng district's website (accessed 19 May 2017), http://www.xjtc.gov.cn/info/1186/133037.htm

[782] Situation as regards the implementation of the reduced price policy: Textile enterprises located in Xinjiang benefit from reduced electricity prices, which reduces their expenses by RMB 100 million per year. Source: Xinjiang Uygur Autonomous Region Development and Reform Commission, 31 August 2015 http://www.xjdrc.gov.cn/info/10509/229576.htm (accessed 01/06/2017).

[783] Xinhua, (2016). 新疆实施"精准补贴"提升纺织服装产业竞争力 http://news.xinhuanet.com/2016-08/15/c_1119391395.htm (accessed on 23 August 2017).

[784] Nanping City's programme of preferential policies for investments, Source: Nanping City's website (Fujian province), Date: 20th May 2013, http://www.np.gov.cn/cms/html/npszf/2013-05-20/1980306018.html (accessed on 23 August 2017).

rules.[785] According to a State Council notice from 2014, some preferential policies should be cancelled or standardised to ensure compliance: '*Other preferential policies, either payments of the social security contributions or other operating costs on behalf of enterprises, electricity and water preferential prices, in the form of fiscal incentives or subsidies so as to attract enterprises from other regions or so as to keep or increase local fiscal revenues from enterprises in the areas where these policies are implemented shall gradually be standardised*'.[786] In other words, China recognizes that there are distortions that it will address gradually.

A specific NDRC notice prohibiting preferential electricity pricing was issued with regard to aluminium in 2013:

> *Prohibition of spontaneous introduction of preferential price measures applicable to electricity. All provinces and places shall strictly implement the national electricity pricing policy, they may not spontaneously reduce the electricity price applicable to electrolytic aluminium enterprises. Preferential electricity prices applicable to electrolytic aluminium enterprises that are already in force shall be corrected immediately.*[787]

The attempts to stop preferential pricing included an NDRC notice from 2011 (repealed in 2016) on correcting and regulating electricity pricing:

> *Any management policy related to unauthorized price adjustments, any preferential electricity price measures spontaneously taken without prior NRDC approval and exceeding the price management competence of local governments and their related departments; -Any experimentation of direct electricity supply to large users or any other price reduction for electricity used by enterprises that have been developed without authorization and without prior approval of NRDC, the State Electricity Regulatory Commission, the National Energy Administration, shall be stopped immediately.*[788]

However, as the above examples show, despite the fact that preferential pricing seems to be in violation of a number of administrative prohibitions, such practices are still widespread.

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[785] State Council, 国务院关于清理规范税收等优惠政策的通知 国发(Notice on cleaning up and standardising tax and other preferential policies). State Council Legal Affairs Office 2014 No 62: *'[…] some tax and other preferential policies have disrupted the market order, impacted the effectiveness of the national economic macro-control and may breach China's international commitments giving rise to international trade disputes'*. Available at: http://www.gov.cn/zhengce/content/2014-12/09/content_9295.htm (accessed on 10 October 2017)

[786] Ibid., Article 3.

[787] NDRC MIIT, Notice on the implementation of a multiple-tier-pricing of electricity used by electrolytic aluminium enterprises, 国家发展改革委 工业和信息化部关于 电解铝企业用电实行阶梯电价政策的通知 NDRC 2013/2530, 13 December 2013, Article II.i. Available at: http://www.ndrc.gov.cn/zwfwzx/zfdj/jggg/201403/t20140306_590361.html (accessed on 10 October 2017)

[788] NDRC, Notice on correcting and regulating electricity pricing (国家发展改革委关于整顿规范电价秩序的通知), NDRC 2011/1311, Article 1. Available at: http://www.ndrc.gov.cn/fzgggz/jggl/zcfg/201106/t20110623_419213.html (accessed on 10 October 2017)

10.2.1.3. DIRECT POWER PURCHASE

The government is currently promoting direct power purchase by large end-users, with the goal of enhancing competition in the Chinese energy market by bringing additional buyers to the market other than the two power grid companies. The Opinions Regarding the Deepening of the Power Sector's Reform[789] provide for an expansion of current provincial-level pilot programs which allow large end users to bypass grid companies and negotiate prices directly with generators.

Direct power trading can take place in three ways: either using the listed transactions via the electricity trading centres that match electricity generators with energy consumers, using a centralised bidding process (consisting in three steps: calculation, matching and unified clearing) or via means of direct bilateral negotiation (decentralised trading).[790] Bidding on electricity transactions is supposed to improve competitiveness in the energy market as well as to drive prices down. Whereas the system of auctioning ensures a certain degree of fairness to the process, direct bilateral negotiations provide much less transparency.

So far all of the provinces apart from Hainan have set up electric power trading centres.[791] There are in total 33 centres, with two national level trading centres (Beijing and Guangzhou) and 31 at the provincial level.

10.2.1.3.1. Eligibility criteria

Criteria for participating in the electricity direct trade are based on the conditions set out in the Basic Rules for Medium- and Long-term Electricity Trading (provisional)'[792] issued by the NDRC and NEA in December 2016. For example, in Beijing, eligible power generation companies should hold a power generation license, their power generation coal-fired unit capacity should reach at least 300MW/unit or above, and some low coal-consumption units of 200MW or more may participate. Their power units should have desulfurization, denitrification and dust removal facilities. As to electricity users, they shall be included in the latest version of the national Indicative Catalogue of Industry Structural Adjustments[793] and comply with the national and provincial (municipal) energy-saving and environmental

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789 CPC Central Committee and the State Council, Opinions Regarding the Deepening of the Power Sector's Reform, 《关于进一步深化电力体制改革的若干意见（中发〔2015〕9 号）文》全文 March 2015.

790 See the implementing provisions of the Notice on Improving Electricity Direct Trade Between Users and Generators,国家电力监管委员会关于印发《电力用户与发电企业直接交易试点基本规则（试行）》的通知 电监市场[2009] 50 号: Available at: http://www.chinaacc.com/new/63_73_/2009_11_24_wa6058637714211900218684.shtml (accessed on 10 October 2017)

791 Hainan announced a goal to have such a center in place by June 2017, but it is not clear whether this goal was achieved. See: http://shoudian.bjx.com.cn/html/20170516/825776.shtml

792 国家发展改革委 国家能源局关于印发 《电力中长期交易基本规则（暂行）》的通知 发改能源〔2016〕2784 号 http://www.ndrc.gov.cn/zcfb/zcfbtz/201701/t20170112_834884.html (accessed on 10 August.2017).

793 Industrial structure adjustment directory (产业结构调整指导目录): http://www.gov.cn/flfg/2011-04/26/content_1852729.htm and updated by an NDRC notice in 2013: http://www.gov.cn/gongbao/content/2013/content_2404709.htm and an NDRC notice in 2016: http://www.ndrc.gov.cn/zcfb/zcfbl/201604/t20160405_797464.html (accessed on 10.08.2017).

protection standards.[794] The eligibility criteria in Hebei, even though more open, still give a preference to companies listed in the List of Strategic and Emerging Key Products and Services.[795]

There are also specific restrictions with regard to which enterprises can make use of the direct trading system, for example in case of the aluminium industry: '*As regards electrolytic aluminium enterprises whose electricity consumption for aluminium liquid electrolysis does not exceed 13 350 kWh per tonne, the relevant departments of the provincial government shall first support their participation to electricity direct trading. Then, the electricity volume and electricity price shall be determined by the bilateral negotiation'.*[796]

As an example, the process of the verification of participating enterprises in Hebei is as follows:[797]

- Electricity user selection. DRCs (the Industry and Information Departments) at prefectural level (11 in total: Shijiazhuang, Tangshan, Baoding, Handan, Chengde, Zhangjiakou, Qinghuangdao, Langfang, Cangzhou, Hengshui, Xingtai), and at Dingzhou and Xinji are responsible for issuing a notice to solicit the applications of the electricity users. Working together with the local environmental protection department, the land department and the power department, the prefectural DRCs assess the applications in terms of authenticity of the information, accuracy, and the applicants' qualification, and then submit the selected users to the provincial DRC.

- Power plants selection. Hebei Electric Power Trading Centre and Jibei Electric Power Trading Centre are responsible for the solicitation and assessment of the power plants.

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[794] For detailed rules concerning Beijing, see 国家能源局综合司关于同意印发《京津唐电网电力 用户与发电企业直接交易暂行规则》的函, Available at: http://zfxxgk.nea.gov.cn/auto92/201607/t20160729_2280.htm

[795] According to the Hebei DRC Notice from 2016 concerning the 2017 direct power trading: '*Registration conditions applicable to power users: 1. Fulfil the basic conditions set out in the "Hebei Province Power direct trading implementation plan (trial phase)", 2. This time, the registering users' voltage category shall be of 35 kV and above; as regards new high-tech enterprises and enterprises listed on the 2016 "List of strategic and emerging key products and services" the voltage category condition can be relaxed to 10kV and above. 3. Be a user to which a two-tier power pricing is applied; 4. Be a user whose yearly power consumption reaches 10 million kWh or more. Registering users shall fulfil all above-mentioned conditions at the same time.*' See http://www.hbdrc.gov.cn/web/web/dlb_gzdt/4028818b5865836201586c49c3d7778c.htm (accessed on 10 October 2017). 战略性新兴产业重点产品和服务指导目录（2016 版）(List of Strategic and Emerging Key Products and Services): http://www.ndrc.gov.cn/gzdt/201702/W020170204632980447904.pdf (accessed 12 October 2017)

[796] NDRC MIIT, Notice on the implementation of a multiple-tier-pricing of electricity used by electrolytic aluminium enterprises, NDRC 2013/2530, 国家发展改革委 工业和信息化部关于 电解铝企业用电实行阶梯电价政策的通知 发改价格[2013]2530 号, 13 December 2013, Article III.ii. available at: http://www.ndrc.gov.cn/fzgggz/jggl/zcfg/201403/t20140306_615506.html (accessed on 10 October 2017)

[797] See Notice from Hebei DRC: http://www.hbdrc.gov.cn/web/web/dlb_gzdt/4028818b5865836201586c49c3d7778c.htm (accessed on 23 August 2017).

- The provincial DRC will assess the applications and then issue the final list for public consultation. If there are no objections from the public, the participants need to register at the trading centre, and then can officially participate in trading.

In 2016, a total number of 123 user entities were placed on the list of eligible users in Hebei province to participate in direct trading, along with 50 electricity providers.[798] The 123 users include enterprises from the pharmaceutical sector, mining sector, steel and aluminium industry, automotive industry, and chemical industry, among others. In other provinces the numbers of enterprises allowed to participate in direct trading are for example: 339 users and 20 power generators in Guangxi from June 2016 to June 2017 (allowing for savings of RMB 2.83 billion for the users during this period)[799] and 261 users and 25 power generators in Anhui (allowing for savings of RMB 3.14 billion) in 2016.[800] In 2016, 78 companies were covered by direct trading in Henan, which allowed them to save RMB 1.5 billion in total.[801] The savings made on the level of individual enterprises are considerable.

In practice the selection process can lead to distortions by giving specific preferred industries and possibly individual enterprises access to cheaper electricity. This was for example the case in Guangxi. NEA's 2015 Electricity Supervision Report issued in 2016 revealed that instead of choosing trade participants based on the existing criteria, the Guangxi local government directly chose one user and four power plants to have direct trade with a stipulated amount of electricity. [802] Furthermore, it is questionable whether the selection of participating users is always based on objective criteria, as there is evidence of using political pressure to make sure the companies backed by the State are placed on the list of eligible energy buyers.[803]

10.2.1.3.2. Further aspects of application

In the case of certain industries, the government underlines its role in supporting negotiations between the enterprises and power companies as well as electrical grid enterprises. The 13th

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[798] See the full list at the Hebei Government website: http://info.hebei.gov.cn/eportal/ui?pageId=1966210&articleKey=6601777&columnId=330035 (accessed on 23 August 2017).

[799] China Daily, (2017). 广西：企业用电成本降低 28.3 亿元 available at: http://caijing.chinadaily.com.cn/2017-06/01/content_29572884.htm (accessed on 10 October 2017)

[800] Wangyi, (2017). 电力直接交易带来了什么？ See http://news.163.com/17/0123/10/CBF5Q2U900018AOP.html

[801] See Henan government website, (2016) 河南电力直接交易释放改革红利 交易电量已达 240 亿千瓦时: http://www.henan.gov.cn/jrhn/system/2016/09/11/010671121.shtml (accessed on 10 October 2017)

[802] See National Energy Administration, 国家能源局 监管公告 2016 年第 10 号 （总第 43 号） 2015 年全国电力调度交易与市场秩序 监管报告 http://zfxxgk.nea.gov.cn/auto92/201606/t20160614_2265.htm (accessed on 19 December 2017).

[803] See the note of the Hanzhong Municipal Government requesting the Shaanxi local DRC to include Shaanxi Steel Group Hanzhong Iron and Steel Co. Ltd (the largest company in Hanzhong) in the list of companies participating in direct trading. The note underlines the role of the company in the local economy. Source : http://www.hanzhong.gov.cn/xxgk/gkml/zfwj/zfjzfbwj/hzfwj_13925/201507/t20150715_226552.html (accessed on 19 December 2017).

FYP on nonferrous metals includes provisions on governmental involvement into such negotiations:

> *[…] support non-ferrous metal enterprises complying with the sectors' regulations and conditions, energy consumption and environmental protection standards to develop direct electrical supply deals; support electrical power users to negotiate lower grid utilisation charges and back up capacity charges with electrical grid enterprises; […]; reduce the cost of electrical power utilisation; improve the enterprises' economic benefits […].*[804]

As noted previously, there was an explicit provision in the NDRC notice issued in 2011 prohibiting unapproved direct supply arrangements, but such notice was annulled in 2016.[805]

Even though direct trading is subject to a number of legal requirements, in a situation where SOE power generators enter into negotiations with SOE power recipients, clearly in support of specific policy goals pursued by the Chinese government, it can be expected that the prices negotiated between these governmental actors will not be determined solely by free market forces, as is the case now with differentiated pricing for certain favoured industries described in the preceding chapter.

Savings made by individual companies are considerable:

- Aluminium Corporation of China Limited Qinghai Branch (Chinalco – the largest state-owned aluminium producer in China) secured a considerable reduction of costs thanks to direct power purchase. According to the CEO of the company, Chinalco Qinghai was facing the risk of a production reduction. It is thanks to the considerable price cuts due to direct power trading that the company could reach full production and even make some profit.[806]

- Anyang Steel received 900 million kWh of direct electricity supply from power plants, reducing utility expenses by RMB 60 million. This was done under the coordination of the Anyang Government.[807]

- Jiyuan Jinli Group and Wanyang Group, two non-ferrous metal smelting enterprises in Henan concluded electricity deals for 100 million kWh and 115 million kWh

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[804] 13th FYP for Nonferrous Metals, Section V-4.
[805] See Notice on correcting and regulating electricity pricing, NDRC 2011/1311. 国家发展改革委关于整顿规范电价秩序的通知 发改价检[2011]1311 号. http://www.ndrc.gov.cn/fzgggz/jggl/zcfg/201106/t20110623_419213.html. For information regarding its annullment in 2016, see http://www.ndrc.gov.cn/zcfb/zcfbl/201601/t20160113_771254.html and http://www.ndrc.gov.cn/zcfb/zcfbl/201601/W020160113386466096257.pdf (accessed on 19 December 2017).
[806] Chinanews. (2017). 青海年度首次电力直接交易超 200 亿千瓦时(*Direct electricity trade in Qinghai exceeds 20 bn kWh for the first time)*, 13.01.2017, http://www.chinanews.com/m/cj/2017/01-13/8123137.shtml (accessed on 23 August 2017).
[807] Caixin. (2016). 去产能"之困的安钢样本 http://m.weekly.caixin.com/m/2016-01-29/100905030_2.html (accessed on 6 October 2017).

respectively. Since electricity accounts for around a third of their production cost, the direct trading deals cut their costs by RMB 3.61 million and RMB 4.15 million, respectively.[808]

- China Resources Textile (Hefei) Limited Corp. made savings of RMB 3 million and Hefei BOE Photoelectric Technology Limited Corp. made savings of 32 RMB million in 2016 thanks to direct trading and government concessions.[809]

It can be concluded that in their current configuration and with a very limited number of participants, direct electricity trading is a phenomenon leading to considerable distortions with regard to electricity costs for individual companies.

10.2.1.4. SSSR

In July 2017, the government announced that all provincial-level power grids had completed the power transmission and distribution pricing system reform, which is supposed to liberalise prices. This should lower the cost of power use by RMB 38 billion, on top of (1) RMB 18 billion saved from a reform promoting market oriented pricing for power sale and (2) RMB 41 billion saved by cancellation of surcharges and extra rates in power prices for ordinary users and rail carriers. All this should total RMB 100 billion in savings in power use cost in 2017.[810]

Individual provinces also have ambitious goals with regard to reducing corporate cost in the area of energy.

The Province of Guangdong issued an SSSR implementation plan regulating the cost of electricity for enterprises in the province:

> *As of 1st January 2017, in the framework of Guangdong's overall reform of electricity transport and distribution as well as in the framework of further reforms, the electricity sale price shall be decreased. In the whole province, except in Shenzhen city, the electricity price for large industries as well as the electricity price for standard industry and commercial enterprises shall be decreased by RMB 0.0233/kWh. The Guangdong Power Grid Corporation shall reduce the price of the electricity transmitted to the Shenzhen Power Supply Bureau by RMB 0.0233/kWh. The Adjustment Plan for the Shenzhen City*

[808] See Henan government website. (2016). 河南电力直接交易释放改革红利 交易电量已达 240 亿千瓦时: http://www.henan.gov.cn/jrhn/system/2016/09/11/010671121.shtml (accessed on 10 October 2017)
[809] Wangyi, (2017). 电力直接交易带来了什么？ See http://news.163.com/17/0123/10/CBF5Q2U900018AOP.html (accessed on 19 December 2017).
[810] Global Times. (2017). *China to cut power use cost by nearly 100 bln yuan this year*, Available at: http://www.globaltimes.cn/content/1058181.shtml (accessed on 23 August 2017).

electricity sale price shall be published by Guangdong Development and Reform Commission separately.[811]

According to the Shaanxi provincial plan on SSSR, the electricity cost reductions envisaged included a reduction of the sale price by Shaanxi power grid of RMB 0.0517 per kWh for standard industry and commercial enterprises as from January 2016 and a reduction by Yilin Power grid by 0.0275 per kWh for large industry enterprises and by 0.0517 per kWh for standard industry and commercial enterprises.[812] The plan furthermore sets out that electrolytic caustic soda production and calcium carbide production should benefit from the lower electricity fee applicable to large industry production. Furthermore, the plan envisages support for enterprises to build their own power plants.[813]

10.2.1.5. PLANT-OWNED CAPTIVE POWER SOURCES

In case of some very energy intensive energy industries, such as aluminium, the smelters might have their own captive power plants, which visibly reduces the cost of energy transmission. According to the International Energy Institute, 85.4% of aluminium smelters in China had a captive power plant in 2015.[814] However, there are reportedly a number of irregularities and distortions which provide for a considerable cost reduction for those smelters. Whereas it is impossible to prove distortions without investigating every smelter separately, the recent notice by the NDRC and NEA on captive power plant inspections in Xinjiang, Inner Mongolia, Gansu, Guangxi, Jiangsu and Shandong point to the fact that problems exist on the individual smelter level. The inspections will check the basic conditions of coal-fired captive power plants, whether the plants pay fees in accordance with the rules and whether they reach standards with regard to emissions.[815]

Beside the fact that there might be distortions at the level of individual smelters, the captive power plants benefit from the low, subsidised price of coal in China (See Section 12.5.1.3 on coal pricing and Section 10.2.2.1 on coal subsidies).

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[811] Department of finance of Guandong Province, 广东省人民政府关于印发广东省降低制造业企业成本支持实体经济发展若干政策措施的通知 粤府〔2017〕90 号 Available at: http://www.gdczt.gov.cn/zwgk/czxw/201708/t20170825_884703.htm (accessed on 10 October 2017)

[812] Shaanxi People's Government Notice as to preparing an action plan for supply-side structural reform and cost reduction, 陕西省人民政府关于印发供给侧结构性改革降成本行动计划的通知 陕政发〔2016〕38 号 [有效], Article 30. Available at: http://www.sndrc.gov.cn/newstyle/pub_newsshow.asp?id=1024153&chid=100054 (accessed on 10 October 2017)

[813] Ibid.

[814] Fickling, D. (2016). *China isn't the reason U.S. Aluminum is suffering*, Bloomberg. Available at: https://www.bloomberg.com/gadfly/articles/2016-10-10/china-isn-t-the-reason-u-s-aluminum-is-suffering (Accessed on 5 October 2017)

[815] See Sina, 发改委联合 4 部委督查自备电厂，重点抽查新疆内蒙广西山东等 6 省 http://finance.sina.com.cn/money/future/indu/2017-06-15/doc-ifyhfpat4841504.shtml (accessed on 6 October 2017), the NDRC/NEA document 2017/329 From 13 June 2017 《国家发展改革委办公厅国家能源局综合司关于开展燃煤自备电厂规范建设及运行专项督查的通知》（发改电〔2017〕329 号）and NDRC Guiding Opinion on strengthening supervision and management of coal-fired captive power plants 中共中央国务院关于进一步深化电力体制改革的若干意见（中发〔2015〕9 号）

10.2.2. OVERCAPACITY

Substantial subsidies for the production of coal (see Section 10.2.2.1) resulted in serious overcapacity in coal production, which in turn drove the prices down. Low coal prices created an incentive for the creation of new coal-fired power generation, as coal-fired power plants were cheap to run and profitable because of depressed coal prices.

The 12th FYP on coal industry development explains the following reasons for the existence of this overcapacity in energy production: '*Though the coal industry has gone a long way, in the course of the development process some problems related the lack of coordination, imbalances, unsustainability have arisen.* […]'

Overcapacity in turn led to depreciated prices and lack of profitability of the sector. In 2015, 80% of coal firms in China incurred losses.[816] The State therefore continuously sets targets to lower coal production capacity. In early 2017, NDRC announced the plan to cut the coal mines capacity by 300 million tonnes by 2020. The 13th FYP on the Coal Industry Development repeated the language of the 12th FYP regarding the reasons for the overcapacity, and then added additional details:

> *Though the coal industry has gone a long way, in the course of the development process some problems related the lack of coordination, imbalances, unsustainability have arisen. Coal production overcapacities: because of the impact of the economic slowdown, of the structural adjustment in the field of energy and other factors, the demand for coal has gone down, and the supply capacity has become excessive.*

The Plan furthermore states that: '*There are coal production overcapacities and the supply/demand ratio is severely imbalanced*.'

Downstream, there is also serious overcapacity in coal-fired power generation. Even though utilisation rates of coal-fired power plants are falling rapidly with the efforts to replace the old polluting technologies with renewable energy sources, over 110 GW of additional coal-fired power plants were still in construction in 2016 and there were still new investment proposals to add additional capacity.[817] Maintaining positive returns in spite of significant overcapacity is possible due to low coal prices, low capital costs, attractive financing and generous power tariffs.[818]

While concerning coal production, the government attempts to tackle the overcapacity issue by setting production targets, the overcapacity in the coal-fired electricity generation sector has seen the government introducing measures to limit the excessive capacity growth by lowering prices for electricity originating from coal-fired power plants. A plan on reducing

[816] IEA, (2016). *World Energy Outlook 2016*, IEA, Paris.
[817] Ibid., p. 226.
[818] Ibid., p. 227.

coal-fired electricity prices issued in 2015 provides that: '*the Standing Committee has decided to cut the coal-fired on-the-grid electricity prices and to reduce in turn by 50% the sales price to the trade and industry sector'*.[819] Apart from restructuring the energy industry, the plan underlines the importance of lowering the price for large domestic electricity users: '[…] *cutting the price of the coal-fired on-the-grid electricity power has a positive and significant effect as regards reducing the burden on enterprises and as regards fostering enterprises' structural optimisation'*.[820]

10.2.2.1. COAL SUBSIDIES

Even though the share of coal is gradually diminishing, there are still considerable subsidy programmes to coal and coal-fired electricity generation.[821] According to estimates by the International Institute for Sustainable Development ('IISD'), the amount of subsidies to coal-fired generation in China was at least RMB 252 billion in 2014 and RMB 120 billion in 2015,[822] and the subsidies to coal production amounted to RMB 35.7 billion, excluding credit support worth between RMB 3.5 and 35.7 billion.[823] IISD identified 14 subsidies to coal-fired power generation and 18 subsidies to coal production. The most significant subsidies to coal production include: temporary tax and fee relief from provincial and local governments, investment in fixed assets from the State budget, compensations for the coal mines that are shut down in the coal phase-out plan, value-added tax (VAT) rebates, direct subsidies to listed coal companies, coal-bed methane production subsidies, research and development support from the State budget and a special fund for risky exploration of overseas mine resources.[824] Support to coal-fired electricity production includes mergers and acquisitions support, subsidies to 'zombie' companies, subsidies for investment in emissions abatement equipment, power grid investment, as well as credit support.[825]

10.3. CHAPTER SUMMARY

China is currently the world's largest power producer. Around 50% of the generation capacity is state-owned as well as the entire transmission grid. 21 SOEs controlled by the central SASAC are active in the energy sector.

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[819] Chinese Government Website, (2015), 降低煤电价格 促进节能减排(Cutting coal-fired electricity prices, promoting energy saving and emission reductions), 24 December 2015, http://www.gov.cn/zhengce/2015-12/24/content_5027262.htm (accessed on 23 August 2017).
[820] Ibid.
[821] See also section 0 on coal price regulation.
[822] Denjean, B., Su, T., Attwood, C., Bridle, R., Duan, H. and Gerasimchuk, I. (2016). *Subsidies to Coal Power Generation in China*. Geneva: GSI. Retrieved from https://www.iisd.org/sites/default/files/publications/subsidies-coal-power-generation-china.pdf
[823] Xu, H., Wang, H., Bridle, R., Garasimchuk, I. and Attwood, C. (2015). *Subsidies to Coal Production in China*, Geneva: IISD, 2015. https://www.iisd.org/sites/default/files/publications/subsidies-coal-production-in-china.pdf
[824] Ibid.
[825] Denjean, B., Su, T., Attwood, C., Bridle, R., Duan, H. and Gerasimchuk, I. (2016). *Subsidies to Coal Power Generation in China*. Geneva: GSI. Retrieved from https://www.iisd.org/sites/default/files/publications/subsidies-coal-power-generation-china.pdf.

The energy market has undergone a number of changes and reforms and as part of these reforms, central price setting was gradually removed. However, energy prices in China are still not market-based. Prices are still largely controlled by the state. While regulatory control is normal for this sector, the Chinese energy sector has a number of features that go beyond it.

One of the most important issues is the way in which prices are differentiated for different industries. Differentiated prices can also be found elsewhere, for instance for customers consuming large quantities or energy used in off-peak periods, or the differentiation between residential and industrial consumers. However, the price differentiation observed in China appears to favour certain industries and the report provides some examples at the provincial level. The Chinese authorities themselves have recognized in a State Council notice from 2014 the legal problems resulting from this approach.

The problem is aggravated by the recent policy of promoting direct power purchase. Participation in this scheme is linked to meeting certain eligibility criteria which pursue policy objectives. Examples of such criteria are:

- electricity suppliers must have a minimum size,
- users should be included in the national industrial structure adjustment directory and must meet national and local energy saving and environmental protection standards, for instance that their energy consumption per unit produced is below a certain threshold.

These criteria in themselves are already problematic because they provide cheap energy to a subset of industries. The aim of energy saving and environmental protection is misplaced in this context. Moreover, available documents suggest that the purpose of the provision of cheap energy goes beyond promoting energy saving and the protection of the environment, but simply aims at reducing the electricity bills of certain sectors (see 13th FYP on non-ferrous metals).

Last but not least, it is noted that China has in the past provided considerable subsidies for the production of coal which in turn have triggered the construction of coal power plants to an extent that there is now an oversupply of electricity from this source.

The overall picture emerging is one where normal market considerations do not prevail on the Chinese market for energy, given the significant state intervention in production and pricing.

11. CAPITAL

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11.1. INTRODUCTION

This section examines the existing distortions in relation to capital. For this purpose, it assesses access to capital of the different groups of Chinese economic operators, notably private ones and SOEs, the costs of capital as well as the handling of debt at risk. The examination of the handling of debt at risk covers a broad range of issues, in particular it identifies the extent of bad or non-performing loans in the Chinese banking system and the government's response to such loans.

11.2. ACCESS TO CAPITAL

As explained in Chapter 6, the financial system is characterized by a strong State presence and regulatory controls. As a result, SOEs, private businesses with close government ties or business in encouraged sectors are best placed to take advantage of available capital,[826] thus crowding out other players on the market, who are forced to turn to so-called shadow banking

[826] See for example: Bai C., Hsieh C-T., Song Z. (2016). *The long shadow of a fiscal expansion*, BPEA Conference Draft, Brookings Papers on Economic Activity, p. 3.

products to satisfy their financing needs. It follows that, in China, access to capital is not equally available to all market participants. Instead, it is biased in favour of enterprises with ready access to the formal financial system.

A range of studies have found that state ownership in China is positively associated with leverage and access to long term debt, thus creating a positive loan bias.[827] The availability of political connections to help in obtaining bank loans is also a factor for private firms.[828]

The bias in favour of SOE's is visible among others in statistics on the share of loans by ownership type. As can be seen in the figure below, the share of credit going to private enterprises in China has expanded over the years. However, a large share of loans outstanding (47.6% in 2014) still flows to the State enterprise sector.[829]

Table 10: Stock of enterprise loans by type – share of total outstanding

		2010	2011	2012	2013	2014
Total		100,0%	100,0%	100,0%	100,0%	100,0%
State Control		52,2%	48,8%	47,6%	46,5%	47,6%
Collective Control		9,4%	10,0%	9,3%	8,3%	8,0%
Private Control		30,1%	33,5%	36,2%	39,4%	37,8%
HK, Macau & Taiwan Funded Control		4,0%	3,8%	3,6%	3,4%	3,8%
Foreign Funded Control		4,3%	3,9%	3,3%	2,5%	2,8%

Source: Lardy N. (2015). *Markets over Mao: The Rise of Private Business in China*.

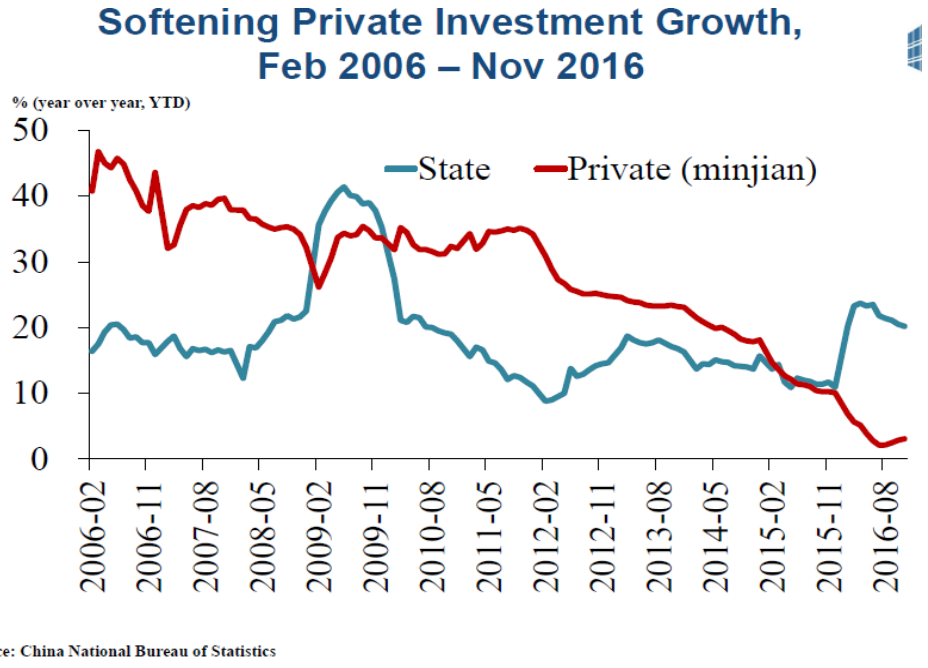
From a macroeconomic view, one can also point to the recent growth in corporate leverage in the State sector despite a sharp fall in profitability. This development suggests that the mechanisms at work in the banking system go beyond normal commercial responses. Indeed, SOEs appear to have been repeatedly pressed into boosting investment when the cyclical position of the Chinese economy has weakened. This was most evident during the financial crisis in 2007/8, and more recently again in early 2016, as can be seen in the chart below:

[827] Firth M., Lin C., Wong S. (2009). *Leverage and investment under a state-owned bank lending environment: Evidence from China*; Li K, Yue H, Zhao L. (2009). *Ownership, Institutions and capital structure: Evidence from China*; Garcia-Herrero A, Gavila S, Santabarbara D. (2009). *What explains the low profitability of Chinese Banks?*; Poncet P., Steingress W., Vandenbussche H. (2010). *Financial constraints in China: Firm level evidence*; Guariglia A, Liu X, Song L. (2011). *Internal finance and growth: Micro-econometric evidence on Chinese firms*; He D, Wang H. (2013). *Monetary policy and bank lending in China – evidence from loan level data*.

[828] Firth M., Lin C., Liu P., Wong S. (2009). *Inside the black box: Credit allocation in China's private sector*; Li H., Meng L., Wang Q., Zhou L. (2008). *Political connections, financing and firm performance: Evidence from Chinese firms*; Du J., Bian C., Gan C. (2017). *Bank competition, government intervention and SME debt financing*, China Finance Review International, Vol. 7 Issue: 4, pp.478-492.

[829] IMF. (2016). *People's Republic of China: Selected Issues*, IMF Country Report No. 16/271, p.38.

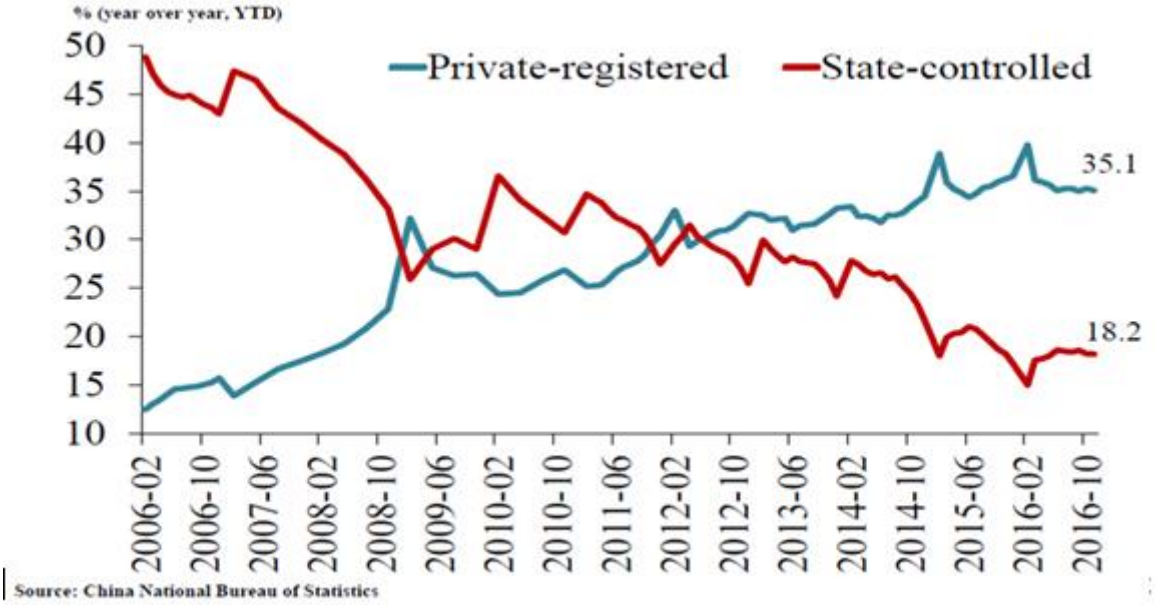
Figure 17: Evolution of investment: private companies vs. SOEs



Source: Lardy N. and Solomon M.A. (2017). *State Resurgence in China?*, Peterson Institute for International Economics, , p.3.

This trend becomes even more evident when comparing the private and the State sector in terms of share of profits in the GDP, as can be seen in the figure below:

Figure 18: Share of industrial profits 2006-2016



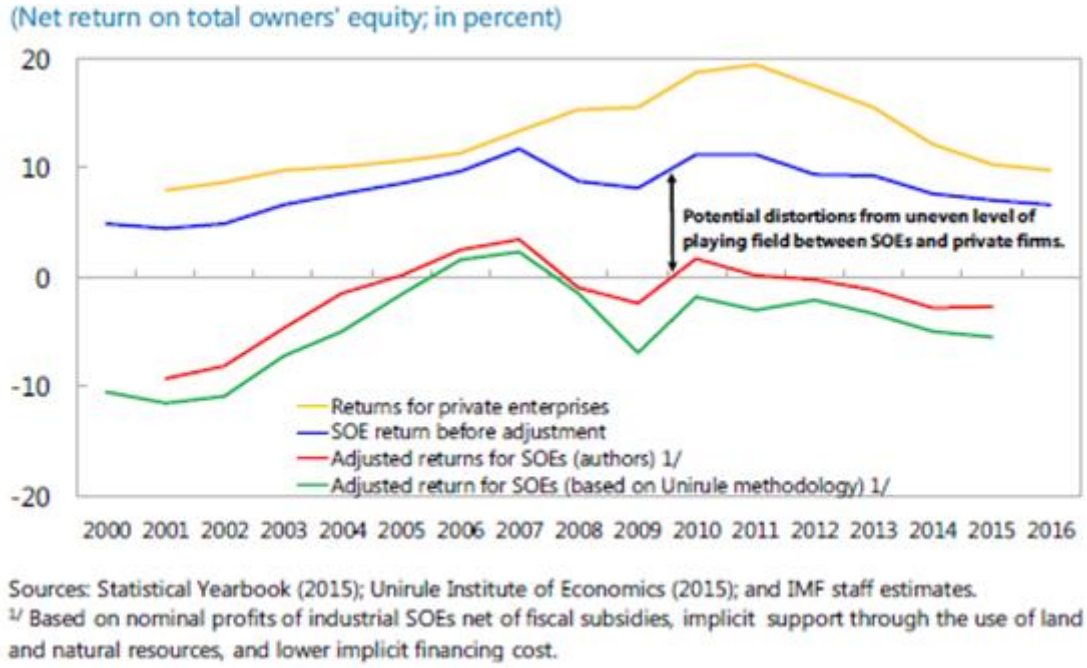
Source: Lardy N. and Solomon M.A. (2017) *State Resurgence in China?* Peterson Institute for International Economics, p.2.

Since the financial crisis, private sector profitability has constantly increased, but investment has decreased. In contrast, state sector profitability has constantly decreased, whereas investment has peaked in the years after the global crisis and again as of the end of 2015. Several very recent papers document the causes of this rise in leverage and corroborate this

assessment.[830] They typically find that within the industrial sector, SOEs have sharply increased leverage in recent years, while private firms have reduced leverage. The increased leverage of SOEs can be explained by the falling profitability of SOE industrial firms combined with the pressure on state firms to increase spending in response to the global financial crisis. These two pressures acted jointly to push up leverage. The corollary of this assessment is that the banking sector may have been unusually lax in extending credit.[831]

This further corroborated by the latest Article 4 report of the IMF, which notes that SOE productivity is a quarter lower on average than for non-SOEs. The IMF further states that '*this lower profitability is especially striking given that SOEs receive substantial implicit support, for example through credits or land, which are estimated at about 3% of GDP, even excluding other benefits such as operating in protected markets'*.[832] The following figure further illustrates this statement:

Figure 19: SOE return on equity



Source: IMF. (2017). *Country Report* No. 17/247, August 2017, p.15.

From a more microeconomic point of view, according to the World Bank Enterprise Surveys, access to finance is identified as the biggest obstacle for private business in China.[833] This is

[830] Chivakul M., Lam R. (2015). *Assessing China's corporate sector vulnerabilities*, IMF Working paper WP/15/72; Ma G., Laurenceson J. (2016). *China's Debt Challenge: stylised facts, drivers and policy implications*; Roberts I., Zurawski A. (2016). *Changing patterns of corporate leverage in China: Evidence from listed companies*; Zhang W., Han G., Ng B., Chan S. (2015). *Corporate leverage in China: Why has it increased fast in recent years and where do the risks lie?*
[831] Ibid.
[832] IMF. (2017). *Country Report* No. 17/247, August 2017, p.15.
[833] World Bank. (2012). World Bank Enterprise Surveys – China country profile.

visible in the table below, showing that in comparison with other countries in the region at a similar development level, reliance on internal finance for investment is very high, and access to bank finance low, despite the size of the financial system in China. When comparing Chinese SMEs with the other countries at a similar development level, it appears that this is even more true for smaller businesses.[834] In this respect, the IMF also recommended Chinese authorities to focus more on creating a level playing field for the private sector by giving the private players (including foreign firms) equal access to resources, such as credit among others.[835] This confirms the bias of the formal financial system towards large firms, as mentioned before.

Table 11: Company use of different financing channels for investment purposes

	China	China small firms	East Asia and Pacific	Upper middle income
Internal finance for investment	89.6	92.1	71.7	62
Bank finance for investment	4.5	0.9	15.1	22.9
Trade credit for investment	1.9	3.8	2.5	5.9
Equity, sale of stock for investment	3.2	2.5	5.2	5.5
Other financing for investment	0.7	0.7	5.6	3.8

Source: World Bank. (2012). World Bank Enterprise Surveys – China country profile.

An additional factor that plays a role are the policy signals provided by Beijing concerning strategic sectors. Recent planning documents such as Made in China 2025 and the 13th FYP are (also) industrial policy documents identifying strategic sectors. Government organisations seek to direct investment into such key projects and industries by, inter alia, offering loan interest subsidies, loan guarantees and other means of reducing capital costs. Moreover, banks and other lenders are supposed to support these policies by giving loans to companies active in such sectors. In this respect, the PBOC meets regularly with large banks to align lending strategies with government objectives, and the PBOC issues industry-specific 'window guidance' to direct credit.[836] As explained in chapter 6.3.3 of this report, this underlying policy is also visible in various other legislations at the national level (Banking Law,

[834] Source: World Bank. (2012). World Bank Enterprise Surveys – China country profile.
[835] IMF. (2017). *Country Report* No. 17/247, August 2017, p.16.
[836] Shevlin A., Wu L. (2015). *China: The Path to Interest Rate Liberalization*, J.P. Morgan Asset Management, p.7; PRC Macro (2016). *Baling China In to the Great State Refinancing*, p.31.

Securities Law or Decision No 40 of 10 October 2010 of the State Council.[837]) All this generates a further lending bias.

Finally, as explained in chapters 6.4 and 6.5 of this report, state intervention and restrictions on access to capital do not only extend to banking loans, but also to the Chinese bond market, as well as to the stock market. Concerning the bond market, chapter 6.4 has explained that access to the market is tightly regulated by governmental institutions, and the major players in the market are mainly state-owned entities.

Concerning the stock exchange, chapter 5.5 explained that access to the Chinese stock market is heavily regulated by the State and that many of the firms listed on the stock exchanges are state-owned. In addition, there are restrictions on a substantial number of shares issued (since they are either non-tradable or not accessible to foreign investors).

As a result, neither bond nor stock markets in China have been effectively allocating resources in the economy. Their functioning should rather be seen as an extension of the loan/capital bias of the banking market to other sections of the formal financial system.

11.3. CAPITAL COST

China has until recently maintained caps on deposit rates and loan rates. They were considered to be an important instrument in maintaining guaranteed interest margins for banks and limiting competition for both loans and deposits. The guaranteed interest spread thus prevented the formation of a true risk culture, which is key to commercial banking, capital market development, and access to finance.[838] Caps on loan rates were finally abolished in 2013 while caps on deposit rates were abolished in October 2015.

Although China has now established a more typical interest rate 'corridor' approach, the PBOC itself still continued to refer to 'benchmark' interest rates in recent notices issued in 2016[839], and a recent PBOC working paper also established that deposit and loan rates remained closely tied to the benchmark rates.[840]

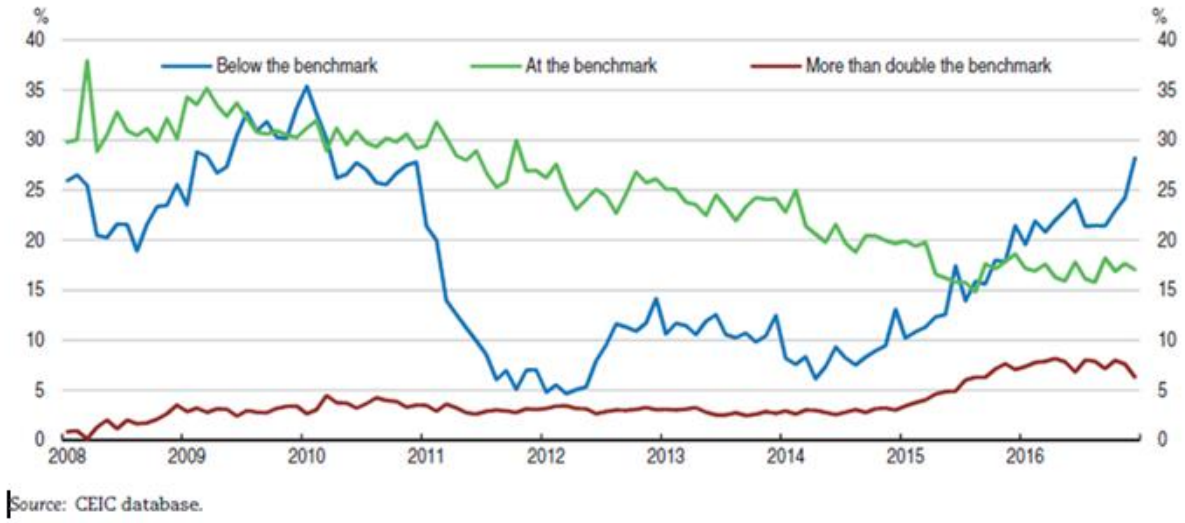
Since the abolition of the caps, credit pricing seems to have improved as the share of loans at the benchmark rate has diminished while the share well above has increased (see figure below). However, while the share of lending at the benchmark rate has decreased, the share of

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[837] For further details on the specific legislation, see chapter 6.3.3 of the report.
[838] The World Bank & Development Research Center of the State Council of the People's Republic of China. (2013).*China 2030: Building a Modern, Harmonious, and Creative Society*, p.119
[839] See e.g., *Notice of the People's Bank of China, the China Banking Regulatory Commission, the China Insurance Regulatory Commission, and Other Departments on Issuing the Interim Measures for the Pilot Program of Granting Mortgage Loans Secured with Farmers' Housing Property Rights*, Article 7 (PBOC, CBRC, CIRC, issued March 15, 2016).
[840] Jun M., Min J., Muhong N., Xiang Z. (2016). *Transmission of Monetary Policy Via the Banking System*, PBOC Working Paper No. 2016/4, p.6.

lending below the benchmark rate – after a significant drop in 2011/12, has considerably increased and is now close to the peak achieved in 2010. In short, the share of lending at or below the benchmark rate still represents 45% of all lending and recourse to targeted credit appears to have been stepped up, since this share has increased markedly since 2015 in spite of worsening economic conditions.[841]

Figure 20**: Percentage of lending by interest rate relative to the benchmark interest rate**



Source: OECD. (2017). *OECD Economic Surveys: China 2017*, OECD Publishing, Paris, p.22.

There remain some other distinctive features. China in particular has made use of selective liquidity support. This can influence both the pattern and level of lending rates to specific sectors. For example, the PBOC has extended collateralized loans to banks for relending to the SME and agricultural sector, while other instruments such as pledged supplementary lending and the medium-term lending facility can also provide selective liquidity support.[842]

According to calculations by IMF staff, measures that reduce capital costs to some lenders have resulted in costs to the economy in a range of about 4% of GDP per year. Most recently, the IMF article IV report for August 2016 stated that '*Staff estimates suggest that implicit guarantees translate to a 4-5 notch upgrade in credit ratings, and appear to lower borrowing costs by 1-2 percent. As borrowing costs are not commensurate with returns and risks, they distort the allocation of resources and promote inefficiency'*.[843] A later working paper puts the effect slightly lower, at 2-3 credit notches and 0.5% to 1% interest rate advantage for enterprises with an implicit guarantee.[844] It is noted that these are statements applying to the Chinese economy in general and not to specific enterprises. Indeed, findings made in various EU trade defence investigations suggest that the upgrade in credit ratings and the

[841] OECD. (2017). *OECD Economic Surveys: China 2017*, OECD Publishing, Paris, p.22. Detailed figures can also be found in the China Quarterly Monetary Policy Report issued by the PBOC.
[842] Ibid.
[843] IMF. (2016), *People's Republic of China: Selected Issues*, IMF Country Report 16/271
[844] Maliszewski, W. et al. (2016). *Resolving China's corporate debt problem*.

corresponding savings in borrowing costs are much higher in certain industrial sectors and for specific companies.[845]

In addition, several EU anti-subsidy investigations over the past years have concluded that loans had been provided to Chinese companies under investigation below normal commercial market rates regardless of the companies' financial and credit risk situation.[846] Each of these investigations concerned products or sectors that were considered to be 'key' or 'encouraged' areas by the Chinese government.

Whatever the price charged for new loans, actual interest costs also depend on how the existing stock of loans is turned over. For existing loans on the books there may be an incentive for banks to defer or lower interest rates charged to increase viability and reduce write-offs (evergreening). The counterpart is a high level of estimated NPLs. Such practices will be further discussed in the next section.

11.4. HANDLING OF DEBT-AT-RISK

11.4.1. SYSTEMIC ISSUES RELATED TO CORPORATE DEBT

China's economic growth became increasingly credit-intensive after the 2008-2009 financial crisis, to which China responded with a large stimulus package to meet the country's economic growth rate, sourced largely through local government and SOEs, with the finance provided by a large credit expansion by the banking system. Although the pace of credit growth subsequently slowed in 2010/11 it has again picked up as the underlying structural problems linked to China's high investment rate and declining return on capital investment have resurfaced.[847]

As a result, according to data from the Bank of International Settlements, by September 2016 China's non-financial sector debt had reached 255.6% of nominal GDP, which is far above the average for emerging markets. This rise in leverage has been very abrupt, since the debt-to-GDP ratio only stood at 141.3% at the end of 2008. Corporate sector debt accounted for 65% of total debt in September 2016, equivalent to 166% of GDP.[848] At the same time, credit growth has been averaging around 20% per year in the period 2009-2015.[849]

This growth of credit has raised systemic risks. While the returns on some investments undertaken during the stimulus following the global financial crisis may have proven high, in

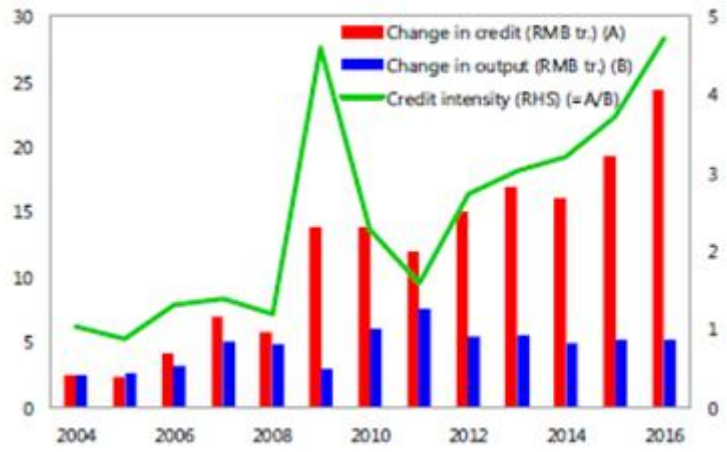
[845] See, amongst others, Commission Implementing Regulation (EU) 2017/969 (OJ L 146, 8.6.2017, p. 17) (*Hot rolled flat steel products*); Council Implementing Regulation (EU) No 452/2011 (OJ L 128, 14.5.2011, p. 18) (*Coated fine paper*), Council Implementing Regulation (EU) No 215/2013 (OJ L 73, 15.3.2013, p. 16) (*Organic coated steel);* Commission Implementing Regulation (EU) 2017/366 (OJ L 56, 3.3.2017, p. 1) (*Solar panels*); Commission Implementing Regulation (EU) No 1379/2014 (OJ L 367, 23.12.2014, p. 22) (*Filament glass fibre*); Commission Implementing Decision 2014/918/EU (OJ L 360, 17.12.2014, p. 65) (*Polyester Staple Fibers*).
[846] Ibid.
[847] Anzoategui, D., Chivakul, M. and Maliszewski, W. (2015). *Financial Distortions in China: A General Equilibrium Approach*, IMF Working Paper WP/15/274, p 1.
[848] The Economist Intelligence Unit, (2017), *China's supply-side structural reforms*, p.15
[849] Maliszewski, W. et al. (2016). *Resolving China's corporate debt problem*. p. 2.

many cases investment did not fully cover the costs. Following the crisis this problem has become embedded in the Chinese economic structure. Investment by local government and state firms has been used to boost demand when the economy falters, so as to keep pace with annual growth targets.

The economy has thus been locked in a fundamentally unsustainable vicious circle: slowing the growth of credit would risk sharply reducing activity and profits in several sectors of the economy. A continued high rate of credit expansion linked to high investment rates prevents this from happening by supporting demand in the short run, but at the cost of higher debt. This process can continue provided the returns on investment are sufficiently high to service the additional debt, but China's high investment rate and slowing growth suggest an increasingly inefficient allocation of capital.[850]

The credit-based stimulus policy has thus led to an excessive use of debt instruments. This contributed to massive overinvestment in capital intensive industries, which in turn caused the formation of overcapacities.[851] At the same time, corporate profits were deteriorating. As more and more capital got invested in projects with lower returns on investment, the quality of bank assets declined, and debt-at-risk increased.[852] As a result, the credit intensity of growth has continuously increased, as can be seen in the figure below:

Figure 21**: Credit intensity**



Source: IMF. (2017). *Country Report* No. 17/247, August 2017, p.40.

This is most visible in the sectors of the economy which were most involved in stimulus spending, i.e. local governments which were pushed by central government to provide the

[850] Anzoategui, D., Chivakul, M. and Maliszewski, W. (2015). *Financial Distortions in China: A General Equilibrium Approach*, IMF Working Paper WP/15/274, p 1.
https://www.imf.org/external/pubs/ft/wp/2015/wp15274.pdf
[851] EUCCC. (2016). *Overcapacity in China: An Impediment to the Party's Reform Agenda*, p 8.
[852] Maliszewski, W. et al. (2016). *Resolving China's corporate debt problem*. pp. 3-4. See also The Economist Intelligence Unit. (2017). *China's supply-side structural reforms*, p.3

bulk of the support to industry and industries with overcapacities, as will be described in greater detail below.

11.4.2. THE ROLE OF LOCAL GOVERNMENTS IN THE CURRENT DEBT CRISIS

Following the global financial crisis in 2008, local governments undertook major spending projects to keep economic growth on track and much of this was financed through so-called 'local government financing vehicles' ('LGFV').[853] LGFVs are state-owned companies that raise funds for local governments.[854] Many of the local level SOEs are LGFVs.[855] These entities may assume various names, such as corporations for city construction investment, city asset investment or urban development investment.[856] The local government is the sole or dominant shareholder in the LGFV which raises capital to finance the local government's investment projects.

A typical arrangement is that the local government transfers ownership of land to the local financing vehicle, and the land is used as collateral to borrow from banks' wealth management products ('WMPs'), trusts or the bond market. In addition to the land use rights, the local government can also use other collateral in exchange for equity ownership, such as highways or bridges and general budget revenues.[857] The local government directly or indirectly shares the debt servicing responsibilities, and sometimes subsidizes the losses of LGFVs.[858]

In this context, it is important to note that there is a mismatch in provincial finances between centralised revenue generation and local spending responsibilities.[859] In fact, local governments account for around 80% of total budgetary expenditures. At the same time, however, they receive only 40–50%[860] of tax revenues as returns from the central

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[853] Bai, C.E., Hsieh, C.T. and Song, Z. (2016). *The long shadow of a fiscal expansion*, BPEA Conference Draft, September 1, 15–16, 2016, Brookings Papers on Economic Activity, p. 1-2

[854] Zhang, M. (2013). *China's Local Government Financing Vehicles (LGFV): 7 Things You Should Know About China's Local Debt Bomb*, 27 September 2013, http://www.ibtimes.com/chinas-local-government-financing-vehicles-lgfv-7-things-you-should-know-about-chinas-1411694

[855] Batson, A. (2014). *Fixing China's State Sector*, Paulson Policy Memorandum, January 2014, p 12

[856] Hou, Y. and School, M. (2016). *Interpreting China's Fiscal Reforms and the 13th Five-Year Plan Targets*, , Testimony before the U.S.-China Economic and Security Review Commission (USCC), Syracuse University April 27, 2016, p 9,

[857] Dong, Y. (2015). *Understanding the Risk of China's Local Government Debts and Its Linkage with Property Markets*, National University of Singapore, Paper, December 2015, p 14. Bai, C..E, Hsieh, C.T. and Song, Z. (2015). *The long shadow of a fiscal expansion*, BPEA Conference Draft, September 1, 15–16, 2016, Brookings Papers on Economic Activity, ,p 1, 6, 8-10; Dorrucci, E., Pula, G. and Santabarbara, D. (2013), *China's Economic Growth and Rebalancing*. European Central Bank, Occasional paper series, no 142, February 2013; Clarke, D. and Lu, F. (2016). *The Law of China's Local Government Debt Crisis: Local Government Financing Vehicles and Their Bonds*, GW Law School Public Law and Legal Theory Paper No. 2016-31, Financial Times, *The debt dragon: Credit habit proves hard for China to kick*. https://www.ft.com/content/f43a4dda-08f2-11e3-ad07-00144feabdc0 (accessed on 15 november 2017)

[858] Zhang, Y.S. and Barnett, S. (2014). *Fiscal Vulnerabilities and Risks from Local Government Finance in China*, , IMF Working Paper WP/14/4, January 2014, p. 4

[859] Deutsche Bank: China's Provinces, research briefing, 11 June 2015, p. 1, 7-9

[860] Estimates vary to some extent and some sources put the figure to around 60%.

government.[861] In sum, fiscal revenue is mostly collected by the central government but mostly spent at the local level.[862] The higher degree of decentralisation of expenditure responsibilities relative to revenues has led to financing gaps at the sub-national level which are only partially filled by fiscal transfers.[863]

In addition, on-budget borrowing by local governments is limited and tightly regulated by the central government. However, the LGFV debt does not show up on the balance sheet of the central government, and therefore local governments are free to raise funds without violating the budget law.[864] Local governments therefore rely extensively on such off-budget mechanisms to finance priority spending, and in particular infrastructure investment.[865]

Finally, investments are important for local officials because companies boost employment in the region and improve tax revenues in the medium term. Traditionally, an official's career development was determined by positive local GDP growth data, industrial production and visible physical changes in cities. To attract investments, local officials therefore often give implicit lending guarantees to companies. This state of affairs remains the case in many parts of China today. The 2008 stimulus package, which presented local governments with huge amounts of money in early 2009, worsened this trend at the local level.[866]

As a result, local government debt ballooned in the aftermath of the 2008 financial crisis.[867] After stabilizing in 2011, local debt surged again in 2012 as policymakers launched a new wave of infrastructure spending to stabilize the economy.[868]

Various estimates of the local level government debt exist which are not directly comparable. Figures given by the PBOC and the National Audit Office differ, because the latter considers

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[861] World Bank and the Development Research Center of the State Council, P. R. China. (2013). *China 2030: Building a Modern, Harmonious, and Creative Society*. Washington, DC: World Bank, p. 55-56, 58
[862] OECD. (2017). *OECD Economic Surveys: China 2017*, OECD Publishing, Paris, p. 29-30; Hou Y., School M., (2016), *Interpreting China's Fiscal Reforms and the 13th Five-Year Plan Targets*, Syracuse University April 27, p. 3; Testimony before the U.S.-China Economic and Security Review Commission (USCC)
[863] OECD. (2017). *OECD Economic Surveys: China 2017*, OECD Publishing, Paris, p. 29-30
[864] Bai, C.E., Hsieh, C.T. and Song, Z. (2016). *The long shadow of a fiscal expansion*, BPEA Conference Draft, September 1, 15–16, 2016, Brookings Papers on Economic Activity, p. 1, 6, 8-10; Dorrucci E., Pula G. and Santabarbara D. (2013). *China's Economic Growth and Rebalancing*, European Central Bank, Occasional paper series, no 142; https://www.ft.com/content/f43a4dda-08f2-11e3-ad07-00144feabdc0; Clarke D., Lu F. (2016). *The Law of China's Local Government Debt Crisis: Local Government Financing Vehicles and Their Bonds*, GW Law School Public Law and Legal Theory Paper No. 2016-31
[865] Zhang, Y.S. and Barnett, S. (2014). *Fiscal Vulnerabilities and Risks from Local Government Finance in China*, , IMF Working Paper WP/14/4, January 2014, p. 5, 13
[866] EUCCC. (2016). *Overcapacity in China: An Impediment to the Party's Reform Agenda*, p. 10,
[867] Wildau, G. (2016). *China local governments revive off-budget fiscal stimulus.* Financial Times https://www.ft.com/content/b303f280-7f14-11e6-8e50-8ec15fb462f4 (accessed on 19 December 2017).
[868] Zhang, M. (2013). *China's Local Government Financing Vehicles (LGFV): 7 Things You Should Know About China's Local Debt Bomb*, 27 September 2013, http://www.ibtimes.com/chinas-local-government-financing-vehicles-lgfv-7-things-you-should-know-about-chinas-1411694 (accessed on 19 December 2017).

LGFV debt only if it is directly backed by local governments.[869] IMF provides figures for 'augmented' debt which includes not only 'on-budget' explicit local government debt (which consists of local government bonds and other recognized off-budget liabilities) but also other types of local government borrowing, including off-budget liabilities (explicit or contingent) borrowed by LGFVs [870] via bank loans, bonds, trust loans and other funding sources.

The National Audit Office estimates that local-government-related debts exceeded RMB 10 trillion by the end of 2010, of which a significant share were deemed to be nonperforming.[871] According to the IMF, local government debt totalled RMB 33 trillion at the end of 2016, equal to 44.3% of GDP. China's augmented fiscal deficit (a figure that includes LGFV borrowing alongside central and local government bonds) reached 10.4% of GDP in 2016, above the finance ministry's official deficit target of 3% for 2016.[872]

The mushrooming of the number of LGFVs and indebtedness has sparked fears about their ability to repay the debt and the consequences of a default.[873] Many LGFV loans obtained in 2008-09 were poorly collateralized and project cash flow estimates were overstated. Local infrastructure projects often take years to generate investment returns, raising the risk of default. In addition, the profits from the projects are often not enough to repay the service of the loans/bonds, and thus LGFVs rely on support from local governments (which are mainly related to land sales revenue).[874]

As such, LGFV activities have contributed to the systemic risks in the financial sector, such as the excessive use of debt instruments, the overinvestment in capital intensive industries, and the increasingly inefficient allocation of credit already described above.

11.4.3. NON-PERFORMING LOANS

In view of the situation described above, it may be surprising to see that according to official figures of the CBRC, only 1.9% of outstanding loans are qualified as NPLs, as shown in the Table below.

[869] Dorrucci E., Pula G. and Santabarbara D. (2013). *China's Economic Growth and Rebalancing*, European Central Bank, Occasional paper series, no 142; Zhang, Y.S. and Barnett, S. (2014). *Fiscal Vulnerabilities and Risks from Local Government Finance in China*, , IMF Working Paper WP/14/4, January 2014, p. 33
[870] IMF. (2017). *Country Report* No. 17/247, August 2017, p. 55,
[871] World Bank and the Development Research Center of the State Council, P. R. China. (2013). *China 2030: Building a Modern, Harmonious, and Creative Society.* Washington, DC: World Bank, p. 31
[872] IMF. (2017). *Country Report* No. 17/247, August 2017, p.43 and 47
[873] Clarke, D. and Lu, F. (2016). *The Law of China's Local Government Debt Crisis: Local Government Financing Vehicles and Their Bonds*, GW Law School Public Law and Legal Theory Paper No. 2016-31
[874] Dong Y. (2015). *Understanding the Risk of China's Local Government Debts and Its Linkage with Property Markets*, National University of Singapore, Paper, p. 14.

Table 12: Official Chinese CBRC estimates of non-performing loans (NPLs)

	2010	2011	2012	2013	2014	2015
NPLs (RMB 100 million)	12 437	10 533	10 746	11 763	14 335	19 624
NPLs (%)	2. 43	1. 77	1.56	1.49	1.64	1.94
Substandard loan	1,1	0,8	0,8	0,7	0,8	1
Doubtful loan	1	0.7	0.6	0.6	0.6	0.8
Loss loan	0.3	0.2	0.2	0.2	0.2	0.2

Source: CBRC. (2015). *Annual report*, Appendix 7 and Appendix 11.

However, official data on NPL are unreliable because the classification of loans does not follow international standards, and a lot of credit risk is not reflected in the balance sheets of the banks because it has been moved off balance through the use of the shadow banking system.

In principle, China follows the international five category system that classifies loans into categories of 'pass', 'special mention', 'substandard', 'doubtful' and 'loss'. The last three categories are scored as NPLs. However, standards and conventions for classification of loans in China do not yet fully follow international norms. At present the official NPL classification suffers from several weaknesses:

- The Basel Committee for Bank Supervision classifies a loan as 'doubtful' when any interest payment is overdue by 180 days or more (90 in the US), while in China this step is often only taken when a principal payment is delayed beyond the loan maturity, or when expectations are that an actual loss will be incurred.[875]
- Classification practices may also vary from bank to bank. *Balding* provides concrete examples of different classification schemes for three banks (Harbin Bank, Bank of Chongqing and Huishang Bank) and also points out that the IPO prospectuses for these banks were explicit that their loan definitions do not reflect best international practice.[876]
- China's classification scheme therefore allows for non-reporting of loans for which payments are overdue, but which the bank deems to be sound. Banks may therefore structure interest payments on products to avoid NPL classification, or restructure

[875] Allen F., Qian J., Qian M., Zhao M. (2012) "*China's financial system, opportunities and challenges*", NBER Working Paper Series, Working Paper 17828, p.13.
[876] Balding, C. (2014). *When a bad loan isn't really a bad loan.* http://www.baldingsworld.com/2014/04/23/when-a-bad-loan-isnt-really-a-bad-loan/ (accessed on 19 December 2017).

loans to avoid classification as non-performing by continuing to 'evergreen' loans (rolling over repayments into the loan principal).[877]

In addition, as noted above, a substantial amount of loan risk has been moved off balance sheet through the use of the shadow banking system. As much of the shadow banking system in China is closely connected to the formal banking system and can be considered as 'bank loans in disguise' this indirect financing creates contingent liabilities for banks.[878]

A wide range of estimates of NPLs are available via private banks and independent analysts.[879] According to these estimates, the real NPL ratio ranges between 6% and 19% of outstanding debt.[880] The situation is even worse in the industrial sectors plagued by overcapacity issues. A 2016 study from UBS[881] found for example that in six overcapacity sectors – coal, metal smelting, cement, glass, aluminium and ship building - earnings before interest and tax are not enough to cover interest payments for about 25-30% of the total number of companies in these six sectors. The study identified various resolution scenarios and concluded that in the 'more likely' scenario, some USD 1-1.5 trillion of additional NPLs would need to be written off by banks.

Table 13: Overview excess capacity sectors

Figure 6: Excess capacity sectors with large debt, rising leverage, low profit margin and capital return

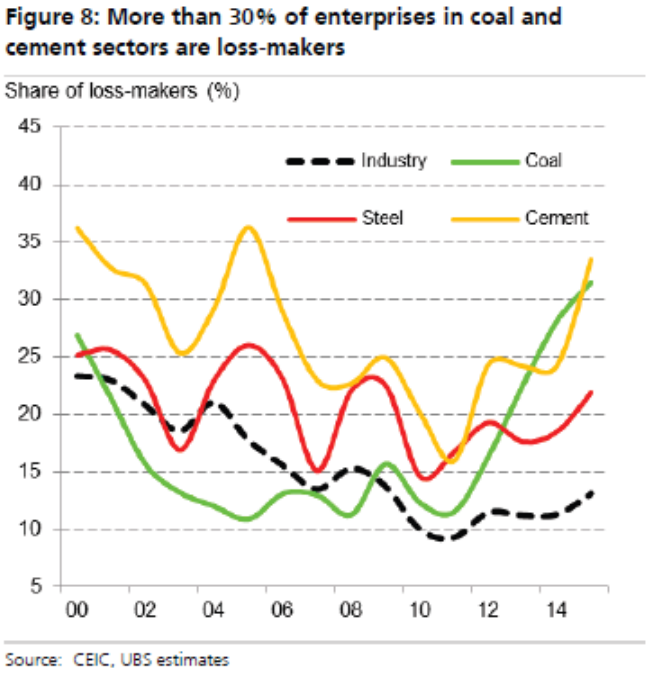
(as 2015)	Assets (RMB trn)	Liabilities (RMB trn)	o/w Debt (RMB trn)	o/w Bank loan (RMB trn)	Liability-asset ratio (%)	Profit margin (%)	Share of loss markers (%)	ROE (%)	ROA (%)
Overall Industrial sector	100.0	56.2	45.6	27.9	56.2	5.8	13.2	14.5	6.4
Coal mining & dressing	5.4	3.7	3.2	1.8	67.9	1.8	31.5	2.5	0.8
Ferrous metal smelting & pressing	6.6	4.4	3.8	2.2	66.7	0.8	21.9	2.4	0.8
Total 6 excess-capacity sectors	14.8	10.0	8.7	4.9	67.3	1.3	26.5	3.0	1.0

Source: CEIC, Wind, UBS estimates

Source: UBS. (2016). *China Economic Perspectives - The economic and financial impacts of Excess capacity reduction.*

[877] Ibid.
[878] See also chapter 6 section 8 of this report.
[879] Such as from the IMF: IMF. (2016). *People's Republic of China: Selected Issues*, IMF Country Report 16/271, p.33. Goldman Sachs, (2016), *NPL and liquidity outlook turning less certain*. HSBC. (2016). *China Banks: Not yet a turning point, but watch the NPL-ABS*. JP Morgan. (2016). *China Banks: The roadmap out of the credit cycle: Part 1: Quantifying NPLs and capital needs.* McKinsey Global Institute. (2016). *China's choice – "Capturing the 5 Trillion dollar productivity opportunity*. Seki Japan Research Institute. (2016). *The growing problem of excessive debt in China*, Pacific Business and Industries Vol. XVI 2016 no.61. CLSA. (2016). see https://www.bloomberg.com/news/articles/2016-05-06/clsa-sees-china-bad-loan-epidemic-with-losses-over-1-trillion.
[880] Results of simulations may differ because of different methods or scope, such as whether they include liabilities linked to local government borrowing, lending via the shadow banking system, and corporate bonds.
[881] UBS. (2016). *China Economic Perspectives - The economic and financial impacts of Excess capacity reduction*.

Figure 22: Share of loss-making entities in steel, coal and cement sectors

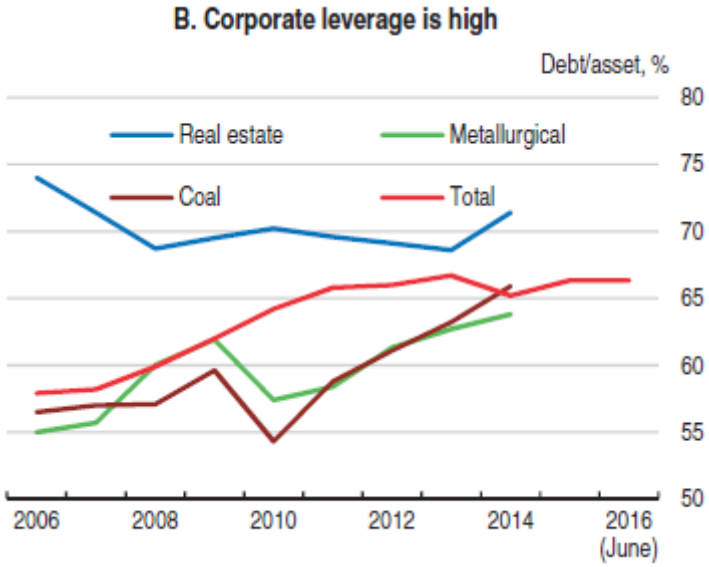


Source: UBS. (2016). *China Economic Perspectives - The economic and financial impacts of Excess capacity reduction.*

Similarly, the Economist Intelligence Unit calculated that at the end of 2015, the coal and steel industries accounted for around 14% of corporate debt within the industrial sector. Based on the annual profits of the coal and steel industries in 2015, it would take 91 and 74 years, respectively, to pay back total debts, compared with an industrial sector-wide average of around 10 years.[882] Similarly, the figure below also confirms that firms in industries suffering from excess capacity display high leverage, in particular in real estate, building materials and metals:

[882] The Economist Intelligence Unit. (2017). *China's supply-side structural reforms*, p.6.

Figure 23: Corporate leverage in excess capacity sectors



Source: OECD. (2017). *OECD Economic Surveys: China 2017*, OECD Publishing, Paris, p. 37.

11.4.4. GOVERNMENT RESPONSE TO DEBT AT RISK

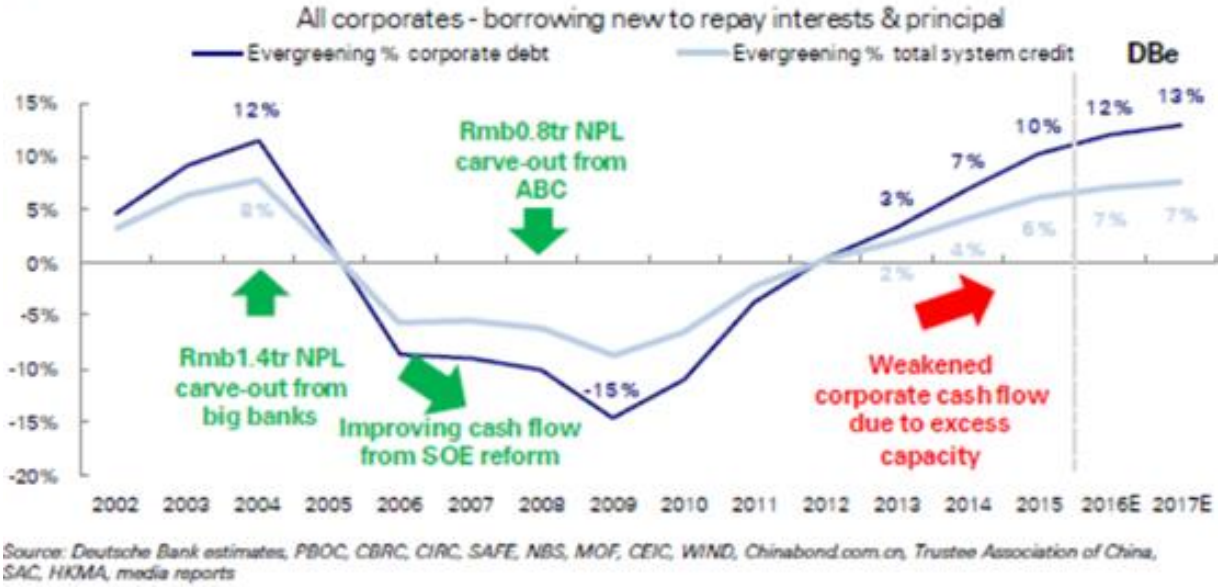
11.4.4.1. EVERGREENING AND ZOMBIE COMPANIES

The first reaction of the government and financial institutions to increasing bad debt problems in recent years has been to 'weather it out', by rolling over debt and providing bailouts or debt restructuring to avoid defaults. For example, Deutsche Bank analysed the extent of 'evergreening' of corporate debt[883] (bank loans, corporate bonds, shadow borrowing) by assessing debt repayment needs in a given year (short term and long term debt) relative to debt servicing capacity (operating cash flows, excess cash, and new equity). The gap between the two is the estimate of loan evergreening. DB calculations use both a top-down and a bottom-up approach.

The top down measure suggests that evergreening of debt was around 10% of corporate credit in 2015. The bottom up measure, based on a sample of 1 500 bond issuers, arrives at a figure of 15%. Under a 'hard landing' scenario, DB estimates that these evergreening rates could imply an NPL ratio for the corporate sector in the range of 13-18%. Deutsche Bank estimates that evergreening has increased since 2010 and is more prevalent in 'overcapacity' sectors (31% of total evergreening). They estimate that these companies have been increasing leverage despite falling profitability.

[883] Deutsche Bank. (2016). *Chinese Banks – the degree of evergreening*, Part 12, 2016.

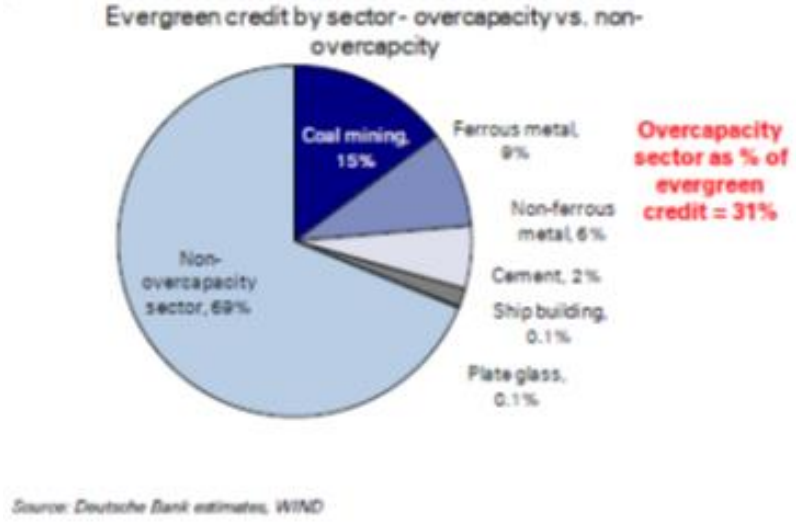
Figure 24: Top-down analysis showing that evergreening credit has been growing since 2009



Source: Deutsche Bank estimates, PBOC, CBRC, CIRC, SAFE, NBS, MOF, CEIC, WIND, Chinabond.com.cn, Trustee Association of China, SAC, HKMA, media reports

Source: Deutsche Bank. (2016). *Chinese Banks – the degree of evergreening*, Part 12, 2016.

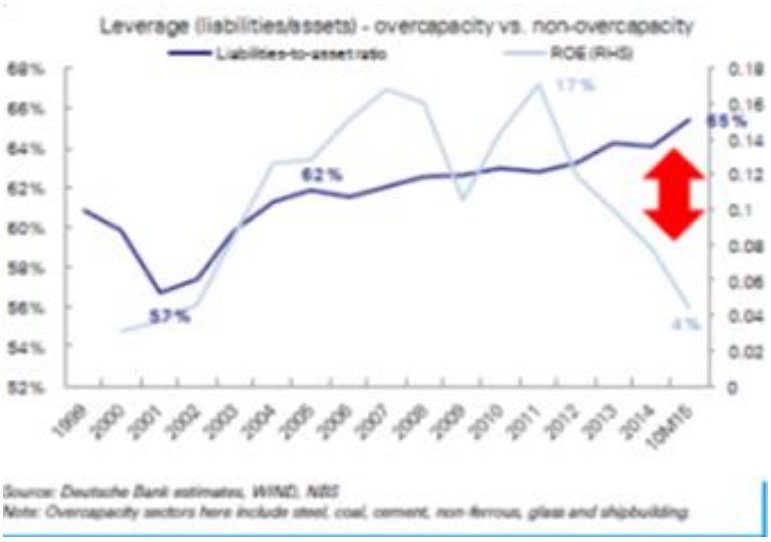
Figure 25: Bottom-up study showing that 31% of evergreening credit is concentrated in overcapacity sectors



Source: Deutsche Bank estimates, WIND

Source: Deutsche Bank. (2016). *Chinese Banks – the degree of evergreening*, Part 12, 2016.

Figure 26: Overcapapcity sectors have been leveraging up, while their profitability declined notably



Source: Deutsche Bank. (2016). *Chinese Banks – the degree of evergreening*, Part 12, 2016.

The existence of evergreening practices was recently confirmed during a press conference in May 2017, during which the director of the local CBRC bureau in Heilongjiang province, which has been heavily hit by the economic slowdown in China, said that his agency had coordinated with creditors to roll over loans to coal and steel companies that cannot repay the capital on their loans, but that were considered to be likely to 'return to health'.[884]

However, this approach has led to an increasing number of so-called 'zombie companies', i.e. companies which are making losses or are unable to service their interest payment obligations but can still obtain loans. At the national level, 'zombie companies' accounted for roughly 14% of all corporate debt in China in 2016, and their numbers have been rising since 2011:

[884] Financial Times. (2017). *Regulator urges China banks to save ailing companies*, https://www.ft.com/content/5455689c-41c7-11e7-9d56-25f963e998b2 (accessed on 13 October 2017)

Figure 27: Share of zombies as a percentage of total industrial firms



Source: IMF. (2017). *Country Report* No. 17/247, August 2017, p.20.

A recent study from Renmin University found that in 2013 Chinese industries with the highest proportion of such 'zombie' enterprises included steel (51.43%), real estate (44.53%), construction (31.76%), retail (28.89%) and comprehensive industry (21.95%). The proportion of zombie enterprises was relatively low in regions with higher economic development levels, while in regions with lower economic development levels, the proportion was relatively high. Seen from the angle of ownership, the proportion was the highest in state-owned and collectively-owned enterprises, and the proportions were much lower in private enterprises. Seen from the angle of scale, large and medium-sized enterprises had the highest proportion of zombie enterprises. Seen from the angle of ages, in enterprises with ages of 1 to 5, only 3% were zombies; in 'old' enterprises aged over 30, about 23% were zombies. [885]

In a well-functioning market economy, poorly performing firms will either improve their efficiency or exit the market. However, this process may be impeded by market distortions, such as inefficient insolvency regimes, bank forbearance, loose monetary policy and impaired banking systems, and the persistence of crisis-induced SME support. Historically, the distortionary effects of 'zombie' firms on healthy firms have concentrated on 'evergreening', which supports inefficient firms and encourages them not to undertake efforts necessary to raise their profitability. The effects of such credit misallocation on the economy could be amplified by loose monetary policy to the extent that it lowers the opportunity cost for banks to bet on the resurrection of failing firms via such forbearance lending.[886]

[885] Huihua N. et al. (2016). *China's Zombie Firms: Cause, Consequence, and Cure*, National Academy of Development and Strategy of Renmin University.
[886] McGowan A., Andrews D., Millot V. (2017). *The walking dead? Zombie firms and productivity performance in OECD countries*, OECD Economics Department Working Papers, No. 1372, OECD Publishing, Paris.

When applied to the situation in China, all the factors mentioned above are present. The above-mentioned study from Renmin University found five major causes for the creation of zombie enterprises.[887]

(1) In order to keep up official success rates and to maintain stability, local governments have continuously extended lifelines to zombie enterprises on the verge of bankruptcy through subsidies and loans, or have exerted pressure on non-zombie enterprises. This has caused non-zombie enterprises to turn into 'zombies' and has made it even more difficult to discard the 'zombie' enterprises.

(2) Once an industry was listed in the key priorities for industrial policy, local governments would rush to support the development of this industry, leading to competition between the various local governments, and thus to overinvestment and overcapacity. As soon as zombie enterprises had emerged in the industry, local governments would then offer preferential policies and subsidies to support their own local enterprises, expecting to 'knock out' enterprises in other regions through their support. In addition, the government issued policies to encourage mergers and acquisitions, even making stipulations that only allow a certain number of big enterprises to be supported, thus providing even more incentives for companies to expand capacity.

(3) In 2008, to cope with the international financial crisis, the Chinese government launched an economic stimulus package with a total investment value of around RMB 4 trillion. However, this investment plan caused excessive investment and blind expansion in some industries, which in turn generated zombie enterprises.

(4) After the global financial crisis in 2008, the world's major economies saw slower growth and less demand, gravely impacting export-dependent industries and enterprises in a short period of time.

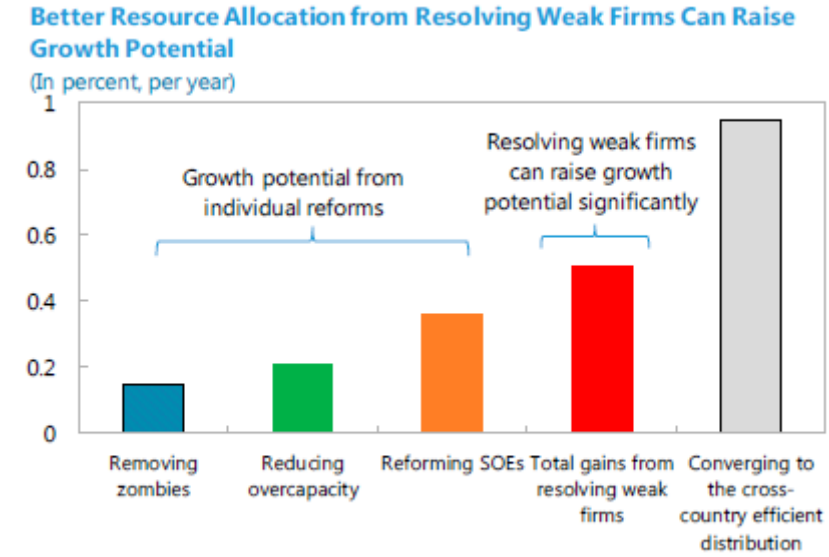
(5) Credit discrimination in banks. After 2008, though the profitability of SOEs went down, it was easier for them to get loans; whereas it was harder for the private companies to get loans even though their profitability levels were very stable.

As a result, 'zombie companies', mainly SOEs in sectors plagued by excess capacity, take up vast resources that could be allocated for more productive purposes. OECD research also shows that zombie-firms aggravate capital misallocation by preventing more efficient firms from expanding, and by dragging down productivity.[888] According to IMF staff estimates, greater progress on resolving weak firms together with convergence to the cross-country

[887] Huihua N. et al. (2016). *China's Zombie Firms: Cause, Consequence, and Cure*, National Academy of Development and Strategy of Renmin University.
[888] OECD. (2017). *OECD Economic Surveys: China 2017*, OECD Publishing, Paris, p 41.

efficiency frontier could increase the contribution of productivity to China's growth by about 1% point over the long term.[889]

Figure 24: Growth potential from various reforms



Source: IMF. (2017). *Country Report* No. 17/247, August 2017, p.11.

According to the IMF, efforts to reduce the number of zombie companies have started, but are incomplete. Indeed, although Chinese authorities reported that 20% of identified 'zombie' central SOEs had been resolved, SOEs continued to account for 50% of zombie debt outstanding in 2016, showing that significant further efforts are needed.[890]

11.4.4.2. TRANSFER OF THE OWNERSHIP OF DEBT

During the previous major credit crisis (at the beginning of the year 2000), the Chinese government dealt with NPLs by injecting fresh State capital into the Big Four banks, and by establishing four Asset Management Companies ('AMCs'), i.e. a 'bad bank' for each Big Four. These AMCs purchased NPLs from the banks and then slowly sold them off to recover part of the losses. Such an approach helped to avoid a banking crisis, but – in itself – did nothing to resolve the underlying corporate governance and misallocation problems.

The current approach of the government to the rising credit crisis consists of a mix of policies, which are to be seen in the context of the broader policies on SSSR, which were set out first in December 2015 at the Central Economic Work Conference, a high-level annual meeting of senior government officials. The SSSR has identified five areas of focus to reduce structural imbalances and financial risks in the Chinese economy. One of these five focal points consists

[889] IMF. (2017). *Country Report* No. 17/247, August 2017, p. 11.
[890] Ibid., p.16.

of corporate deleveraging, i.e. reducing debt ratios in the corporate sector.[891] As part of the corporate deleveraging exercise, the Opinions on Lowering Enterprise Leverage Ratio were issued by the State Council in October 2016.[892] This document follows underlying principles which are similar to the previous AMC approach, since it addresses inadequate corporate leverage mainly by transferring the ownership of the debt through mergers and acquisitions ('M&A') and debt-for-equity swaps, without solving the underlying problems of the distressed companies.

11.4.4.2.1. Mergers and acquisitions

The government is promoting business consolidation and debt restructuring in order to reduce financial risks. For example, the State Council issued a Guiding Opinion on Promoting Structural Adjustment and Restructuring of Central SOEs in July 2016. This document clarifies central SOEs' strategic position and aims at forming a group of innovative and internationally competitive firms. Consolidation is expected by policymakers to drive efficiency gains and to lower financial risks.

Several other regulatory documents corroborate this assessment, as they promote mergers and acquisitions in various ways. For example, the above-mentioned 'Opinions on lowering enterprise leverage ratio' explicitly encourage M&A as a means of corporate deleveraging. In this document, the State Council calls for reinforced efforts to conduct M&As for enterprises in industrial overcapacity sectors, eliminating zombie companies and ineffective ones. It also pledges to strengthen financial support through measures such as granting M&As loans, and encouraging qualified enterprises to raise funds for M&As through issuing preference shares, and convertible bonds[893].

Furthermore, at the level of industrial sectors, the Notice Several Opinions on the Issues of Financial Claims and Liabilities Involved in Resolving Overcapacity of the Iron and Steel Industry and the Coal Industry states that: *'Financial support shall be stepped up for iron and steel enterprises and coal enterprises that engage in merger and reorganization.'*[894]

Similarly, the Guidelines of the PBoC, the CBRC, the CSRC, and the CIRC on Supporting the Steel and Coal Industries to Resolve Overcapacity and Achieve Turnaround in Development state that it is necessary to '*improve the M&A loan business, and expand the*

[891] The Economist Intelligence Unit, (2017), *China's supply-side structural reforms: progress and outlook*, p.3
[892] Document no 54 of the State Council.
[893] Press release of the State Council on issuing the 'Opinions on lowering enterprise leverage ratio and debt-for-equity swap', 10 October 2016.
http://english.gov.cn/policies/latest_releases/2016/10/10/content_281475462906227.htm
[894] NDRC, Ministry of Industry and Information Technology and CBRC, 'Several Opinions on the Issues of Financial Claims and Liabilities Involved in Resolving Overcapacity of the Iron and Steel Industry and the Coal Industry', 2016.

scale of M&A loans, reasonably determine the loan term and interest rate, so as to support enterprises and regions with comparative advantage to integrate the industrial capacity'.[895]

The Ministry of Finance and the State Administration of Taxation have also recently announced preferential tax policies to this end. For example, value-added tax will not be levied on transfers of fixed assets and land-use rights.[896]

However, local officials are often opposed to M&A because of the ensuing loss of influence they may experience. Indeed, since their performance is measured almost entirely on local GDP growth, local government officials try to attract as much investment as possible and then regulate local economic activities in ways that put non-local entities at a disadvantage. The present tax system has added to the reluctance of local governments to agree to M&A, as VAT revenues are based on the manufacturer's location – when a company takes over a local player, the VAT income stream benefits another jurisdiction. With so many 'local champions' being supported under the present system, it is hard for domestic companies to become 'national champions'. [897]

In addition, the question remains how the merger of inefficient groups will actually result in higher efficiency,[898] unless major efforts are undertaken to restructure the merged entities.

A recent example of state-led corporate restructuring is Dongbei Special Steel, which defaulted on ten bond repayments worth RMB 7.1 billion before filing for bankruptcy in October 2016. Government officials from Liaoning province then drafted a bankruptcy reorganization plan, which included among others the acquisition of part of Dongbei's equity by other steelmakers. As a result, in July 2017, Jiangsu Shagang and Benxi Iron & Steel Groups announced that they would invest a combined RMB 5.5 billion in Dongbei, in return for total equity shares of 53%.[899]

11.4.4.2.2. Debt-to equity swaps

The debt-to-equity swap program initiated by the State Council has been one of the measures that has attracted much attention since its initiation in October 2016. The aim of the program is to lower the debt ratios of companies in financial difficulties, and to decrease their financing costs by replacing high-interest rate bank loans with relatively cheaper equity capital. Since its inception in late 2016, the accumulated value of debt-to-equity swap deals has already grown to RMB 774 billion in the second quarter of 2017.[900]

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[895] PBoC, CBRC, CSRC, CIR, 'Guidelines on supporting the steel and coal industries to resolve overcapacity and achieve turnaround in development', 2016.
[896] OECD. (2017). *OECD Economic Surveys: China 2017*, OECD Publishing, Paris, p 18.
[897] EUCCC. (2016). *Overcapacity in China: An Impediment to the Party's Reform Agenda*, p 4, 11-12.
[898] OECD. (2017). *OECD Economic Surveys: China 2017*, OECD Publishing, Paris, p 38.
[899] Caixin. (2017). *Steel Company's restructuring draws creditor ire*, 28 August 2017
[900] Wee D., Tu, L. (2017). *China's debt swaps surpass $100 billion*, Bloomberg, 20 August 2017; BNP Paribas Asset management, *China's debt-equity swaps – a wake-up call for structural reforms*, 2 August 2017

Debt-to-equity swaps for distressed companies also take place outside of China. However, in market economies, the process is normally market driven. In essence, a company in financial distress will offer a swap to the financial market, who will decide whether or not to accept the offer. Depending on the company's financial strength, the debt will be taken over at face value or at a discount. In the Chinese case, the process is essentially state driven.

In China, banks are not allowed to hold directly the equity of distressed companies. They are obliged to set up an 'Implementing Agency', in which they are required to take a minimum stake of 50%. These Implementing Agencies are supposed to convert the banks' loans into equity based on 'market-oriented' prices. The Agencies are also allowed to raise funds from external investors, such as WMP and social capital (insurers, pension funds) to support the swaps. The idea is that banks could then transfer their initial exposure to new investors (i.e. mainly households).[901] As banks do not take direct stakes in the distressed companies, these transactions do not affect their capital reserve requirements. However, in reality, their exposure to the debt-at-risk remains essentially the same, especially if the WMPs are in fact their own subsidiaries. In this respect, China's Big Five banks have all created their own special-purpose subsidiaries serving as initial investors to such equity funds.[902]

In principle, the first thing equity holders would be expected to do in a market economy is to restructure the company and replace its management. But in China, the new owners are actually the banks via their 'Implementing Agencies'. Banks do not necessarily have the know-how or an incentive to manage company restructurings. In addition, the programme has been mainly implemented by the Big Five state-owned Chinese banks. While it is true that a company with good prospects of getting back on track would have no incentive to surrender its equity at a distressed valuation to a state-owned financial institution, the fact that the companies were facing significant financial difficulties suggests that the equity value should have been heavily discounted. Nevertheless, there are indications that swaps are conducted at face value instead of at a discount, since this has been the practice of the previous AMCs since 1999.[903]

The original guidelines issued by the State Council in 2016 mentioned that companies with no financial prospects would not be eligible for debt-to-equity swaps.[904] In August 2017, the CBRC drafted additional guidelines, stating that debt-to-equity swaps should not be implemented for *'"Zombie enterprises" that have no hope of turn-around and have lost any*

[901] The Economist Intelligence Unit. (2017). *China's supply-side structural reforms: progress and outlook,* p.16
[902] Taube M. (2017). *Analysis of Market-Distortions in the Chinese Non-Ferrous Metals Industry,* Think!Desk China Research & Consulting, p.48, Reuters, *China's Big Five banks to set up AMCs for debt-for-equity swaps,* 23 November 2016
[903] BNP Paribas Asset management, *China's debt-equity swaps – a wake-up call for structural reforms*, 2 August 2017
[904] 'Opinions on lowering enterprise leverage ratio', document no 54 issued by the State Council in October 2016

prospect of survival and development'.[905] The idea is that debt-to-equity swaps should only be initiated for enterprises that cannot service their immediate debts but are considered to be financially sustainable in the medium to long term by the lender. Only a limited group of firms conform to both these conditions, thus restricting in theory the potential scale of such measures.[906]

However, in practice, 55% of the swaps initiated in the first half of 2017 have taken place in the coal and steel sector, in which overcapacities and zombie companies are common features.[907] The swaps thus seem to attract mainly bad companies, such as Sinosteel Corp, which received support from the government to avoid a default on its debt in 2015[908] or Yunnan Tin Group, which had a reported debt of RMB 35 billion and a debt-to-asset ratio of 80% before the swap.[909] The deal between China Construction Bank (CCB) and Yunnan Tin raises further questions about the nature of the swaps. First, the debt was purchased at face value. Second, Yunnan Tin must pay out dividends to the parties regardless of its financial performance. Third, Yunnan Tin pledged to repurchase the equity at face value if it did not deliver on certain revenue and profit targets over the next three years. As such, this looks more like a bond than an equity deal.[910] Fourth, CCB raised the majority of the capital from financial institutions and WMPs. This raises concerns over whether the bank will remain exposed to the debts by providing implicit financial support to its WMP.[911]

Thus it seems that in their current form, Chinese debt-to-equity swaps do avoid short-term bankruptcies and loss of employment, but if they are not supported by reforms and productivity gains in the medium-term, they will only postpone the necessary adjustments to the future. In addition, they add to overall systemic risks in the Chinese financial sector, as part of the debt burden is shifted to retail investors and households through WMPs.[912]

11.4.4.3. BANKRUPTCIES

As can be derived from the preceding sections, defaults or liquidation are not the preferred scenarios for companies in distress in China. As a result, the number of insolvency cases has been extremely small for the size of the Chinese economy, only a few thousand per year,

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[905] Notice of the China Banking Regulatory Commission on Soliciting Public Opinions on the "Administrative Measures for the Agencies Newly Established by Commercial Banks for Implementing Debt-to-Equity Swaps (for Trial Implementation)" (Draft for Comments).
[906] OECD. (2017). *OECD Economic Surveys: China 2017*, OECD Publishing, Paris, p. 18.
[907] Natixis, *China Hot Topics*, July 2017 issue; China Banking News, *China's Zombie State-Owned Enterprises benefit from Surge in Debt-Equity Swap*s, 22 August 2017.
[908] Wee, D., Tu L. (2017). *China's debt swaps surpass $100 billion*, Bloomberg, 20 August 2017
[909] Taube M. (2017). *Analysis of Market-Distortions in the Chinese Non-Ferrous Metals Industry*, Think!Desk China Research & Consulting, p.45; Keohane D., (2016), *About China's confusing debt-for-equity swaps*, Alphaville, 20 october 2016; The Economist Intelligence Unit, (2017), *China's supply-side structural reforms: progress and outlook*, p.17.
[910] Keohane D. (2016). *About China's confusing debt-for-equity swaps*, Alphaville, 20 october 2016; The Economist Intelligence Unit. (2017). *China's supply-side structural reforms: progress and outlook*, p.18.
[911] Keohane D. (2016). *About China's confusing debt-for-equity swaps*, Alphaville, 20 october 2016
[912] China Banking News, *China's Zombie State-Owned Enterprises benfit from Surge in Debt-Equity Swaps*, 22 August 2017.

despite the existence of a Bankruptcy Law which is similar to bankruptcy laws in developed countries. As described in chapter 6.9 of this report, enforcement of the Bankruptcy Law remains overall weak and inconsistent. The low reliance on formal bankruptcy also goes along with the absence of defaults on corporate bonds issuance by SOEs, with the first such default as late as 2015, while the first private default occurred in 2014. There has since been a sharp rise in defaults or near-defaults, but these have been handled on a case-by-case basis with differing degrees of state intervention and transparency,[913] and do not seem to promote corporate liquidation.

11.5. CHAPTER SUMMARY

Access to capital for corporate actors in China is subject to various distortions. Firstly, a bias for lending to SOEs, large well-connected private firms and firms in key industrial sectors implies that the availability and cost of capital is not equal for all players on the market. The formal financial system is characterized by a strong State presence and regulatory controls. As a result, SOEs, private businesses with close government ties or business in encouraged sectors are best placed to take advantage of available capital, thus crowding out other players on the market, who are forced to turn to so-called shadow banking products to satisfy their financing needs.

Secondly, artificially low borrowing costs, which are not proportionate in comparison with actual returns and risk, have led to the excessive use of capital investment with ever lower returns on investment. This is illustrated by the recent growth in corporate leverage in the State sector despite a sharp fall in profitability. Indeed, since the financial crisis, private sector profitability has constantly increased, but investment has decreased. In contrast, State sector profitability has constantly decreased, whereas investment has peaked in the years after the global crisis and again as of the end of 2015. These developments suggest that the mechanisms at work in the banking system do not follow normal commercial responses.

Policy signals provided by the Chinese government concerning strategic sectors also play a role. Government organisations seek to direct investment into such key projects and industries by, inter alia, offering loan interest subsidies, loan guarantees and other means of reducing capital costs. Moreover, banks and other lenders are encouraged to support these policies by providing loans to companies active in such sectors. All this generates a further lending bias and non-arm's-length pricing of debt, which fundamentally distort China's financial markets.

Thirdly, although nominal interest rate liberalization was achieved in October 2015, price signals are still not the result of free market forces, but are influenced by government induced distortions. Indeed, the share of lending at or below the benchmark rate still represents 45% of all lending and recourse to targeted credit appears to have been stepped up, since this share

[913] Price, A.H., Brightbill T.C., DeFrancesco R.E., Claeys, S.J., Teslik, A. and Neelakantan, U. (2017). *China's broken promises: why it is not a market-economy*, Wiley Rein LLP, p.69.

has increased markedly since 2015 in spite of worsening economic conditions. Artificially low interest rates result in under-pricing, and consequently, the excessive utilization of capital.

The overall increase in the credit intensity of growth in China indicates a worsening efficiency of capital allocation. As a result, non-performing loans have increased rapidly in recent years. Faced with a situation of increasing debt-at-risk, the Chinese government has opted to avoid defaults (see also chapter 6.9 on bankruptcy issues) and to adopt an approach in which various measures are taken to 'weather the storm'. Consequently, bad debt issues have been handled by rolling over debt, thus creating so called 'zombie' companies, or by transferring the ownership of the debt (e.g. via mergers or debt-to-equity swaps), without necessarily removing the overall debt problem or addressing its root causes.

In essence, despite the recent steps that have been taken to liberalize the market, the corporate credit system in China is affected by significant systemic distortions resulting from the continuing pervasive role of the State in the capital markets.

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12.1. INTRODUCTION

Raw materials are one of the bases of China's rapid economic expansion. This is why security of supply is one of the most important targets, often underlined in the respective sectoral 13th FYPs. China invests a lot into expanding its sources of raw materials, including vast investments into geological exploration in China (RMB 4 766 billion between 2006 and 2015 spent on 382 mineral exploration projects)[914] and acquisitions of mines outside of China (USD 76.8 billion between 2007 and 2017). [915]

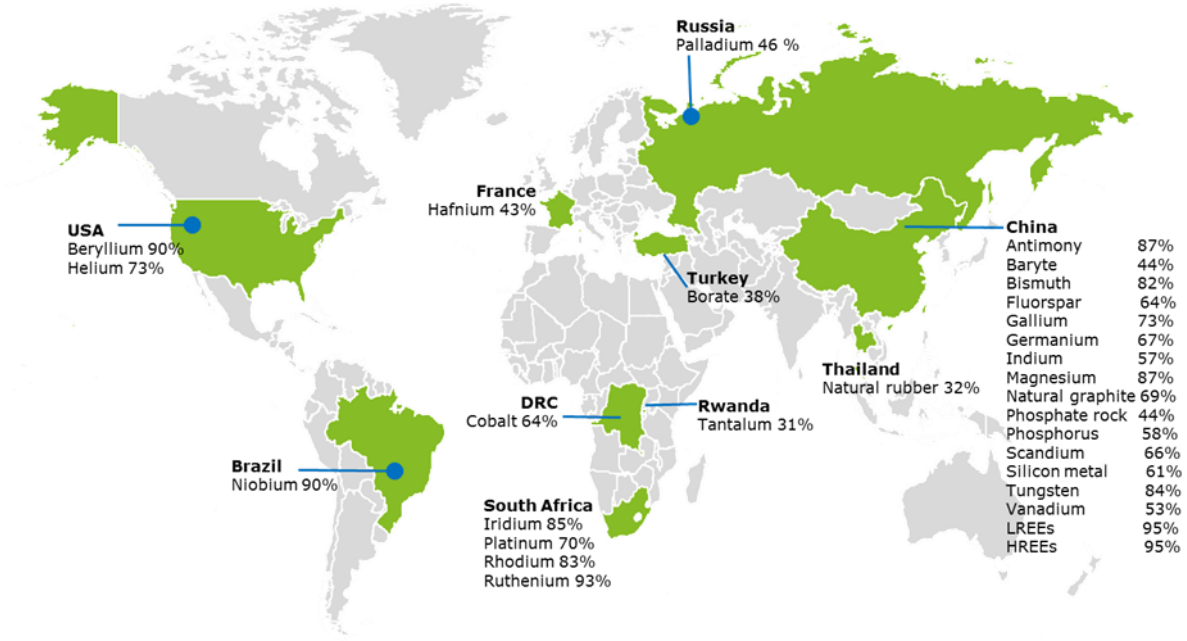
China is an important player on the international market for raw materials. It is the global leader in the production and consumption of raw materials.[916] China possesses the world's largest reserves of: antimony, barite, bismuth, graphite, gypsum, indium, molybdenum, rare

[914] Ministry of Land and Resources. (2016). *China Mineral Resources 2016*, People's Republic of China, Geological Publishing House, Beijing.
[915] The list includes all overseas mine acquisitions of above USD 100 million, according to Bloomberg China Deal Watch: https://www.bloomberg.com/graphics/2016-china-deals/ (accessed on 10 October 2017).
[916] In 2010 China had an overall share of 25.4% of global production of non-energy raw materials (by weight). See Hilpert H.G., Mildner S.A. (2013). *Fragmentation or Cooperation in Global Resource Governance? A Comparative Analysis of the Raw Materials Strategies of the G20*, Stiftung Wissenschaft und Politik German Institute for International and Security Affairs, Bundesanstalt für Geowissenschaften und Rohstoffe (Berlin, Germany).

earth elements, silicon, strontium, tin, titanium, tungsten and vanadium and the second-largest reserves of cadmium, diatomite, lead, lithium, magnesium and zinc. It has furthermore a leading position on iron ore, fluorspar, gold and mercury.[917]

According to the criticality assessment for the 2017 EU List of Critical Raw Materials (CRM),[918] China is the major global supplier of 30 out of the 43 individual critical non-energy raw materials or 70%.[919]

Figure 28: Countries accounting for largest share of global supply of CRMs



Source: The CRM final report (2017), page 15, available at: https://publications.europa.eu/en/publication-detail/-/publication/08fdab5f-9766-11e7-b92d-01aa75ed71a1/language-en (accessed on 12 August 2017).

Furthermore, China is the world's leading exporter of antimony, barite, fluorspar, graphite, indium, rare earth elements and tungsten. It imports large quantities of bauxite, iron ore, copper and nickel, as well as chromium, cobalt, potash, manganese, platinum, tantalum and zirconium.[920]

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[917] Hilpert H.G., Mildner S.A. (2013). *Fragmentation or Cooperation in Global Resource Governance? A Comparative Analysis of the Raw Materials Strategies of the G20*, Stiftung Wissenschaft und Politik German Institute for International and Security Affairs, Bundesanstalt für Geowissenschaften und Rohstoffe (Berlin, Germany).

[918] List available at European Commission's DG Growth website: https://ec.europa.eu/growth/sectors/raw-materials/specific-interest/critical_en (accessed on 10 October 2017).

[919] European Commission. (2017). *Study on the review of the list of Critical Raw Materials. Criticality Assessments*. page 15, available at: https://publications.europa.eu/en/publication-detail/-/publication/08fdab5f-9766-11e7-b92d-01aa75ed71a1/language-en (accessed on 10 October 2017).

[920] Hilpert H.G., Mildner S.A. (2013). *Fragmentation or Cooperation in Global Resource Governance? A Comparative Analysis of the Raw Materials Strategies of the G20*, Stiftung Wissenschaft und Politik German Institute for International and Security Affairs, Bundesanstalt für Geowissenschaften und Rohstoffe (Berlin, Germany).

The Chinese government is influencing the supply and hence the prices of raw materials on the market by using a number of interventionist policies. A significant problem is a mismatch between demand and supply. For example, in 1998 the production of gallium in China accounted for 8 tonnes,[921] going up to 440 tonnes in 2015 and then dropping again to 350 tonnes in 2016 (due to decreasing prices), which still exceeded the worldwide consumption.[922] Large overcapacities are not rare in China and will be described in more detail further below.

The Chinese government takes measures to limit capacity and support downstream products. For example in the case of tungsten (China produces over 80% of the world output), in 2016 there were limits on the numbers of mining and export licenses, production quotas and additional constraints for mining and processing. In 2016 eight large producers in China announced plans to reduce output of tungsten concentrates, the China Tungsten Industry Association asked its members to cut production and China's State Reserve Bureau held tenders to purchase tungsten concentrates.[923]

Another example of governmental industrial intervention is germanium. In the past, the government purchased large amounts of germanium for its stockpile, which had an impact on global prices. At the same time, the Chinese germanium production kept increasing (from 80 000 tonnes in 2011 to 120 000 in 2014[924]). However, in 2016 the prices dropped considerably (decline of 38% for germanium dioxide and 24% for germanium metal). The Chinese government started supporting germanium producers to integrate downstream operations in order to sell more value-added products.[925] Similarly, in the case of indium, the government is expected to increase policy support between 2016-2020 for the development of the downstream industry, potentially leading to a major increase in indium domestic consumption.[926]

This chapter will describe in detail the individual Chinese policies which lead to distortions in the price structure of raw materials, mainly due to governmental intervention taking many different forms.

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[921] Naumov, A.V. (2013) *Status and prospects of world gallium production and the gallium market*, *Metallurgist, Vol. 57, Issue. 5–6, September, 2013, p. 367-371.*

[922] The production capacity in China was even higher, accounting for 600 tonnes per year in 2016. See U.S. Geological Survey. (2017). *Mineral commodity summaries 2017*, U.S. Geological Survey, p. 64 Available at: https://minerals.usgs.gov/minerals/pubs/mcs/2017/mcs2017.pdf (accessed on 10 October 2017).

[923] U.S. Geological Survey. (2017). *Mineral commodity summaries 2017*, U.S. Geological Survey, p. 64 Available at: https://minerals.usgs.gov/minerals/pubs/mcs/2017/mcs2017.pdf (accessed on 10 October 2017).

[924] U.S. Geological Survey, (2013) *Mineral commodity summaries 2013*. U.S. Geological Survey, p. 65, https://minerals.usgs.gov/minerals/pubs/mcs/2013/mcs2013.pdf, and U.S. Geological Survey, (2015) *Mineral commodity summaries 2015.* U.S. Geological Survey, p. 65. https://minerals.usgs.gov/minerals/pubs/mcs/2015/mcs2015.pdf (accessed on 10 October 2017).

[925] In 2016 China's leading germanium producer received a USD 744 000 subsidy from the local city government for the production of downstream germanium products. See U.S. Geological Survey, (2017). *Mineral commodity summaries 2017.* U.S. Geological Survey, p. 71. https://minerals.usgs.gov/minerals/pubs/mcs/2017/mcs2017.pdf (accessed on 10 October 2017).

[926] U.S. Geological Survey, (2017). *Mineral commodity summaries 2017.* U.S. Geological Survey, p. 81, https://minerals.usgs.gov/minerals/pubs/mcs/2017/mcs2017.pdf (accessed on 10 October 2017).

12.2. SCOPE

The raw materials used in the production process can be divided into a number of subgroups, including:

- metals: precious metals, ferrous metals, non-ferrous metals, rare earths etc.;
- industrial minerals;
- mineral fuels;
- agricultural commodities: grains, oils, cotton etc.;
- wood-based products: logs, sawnwood etc.;
- other raw materials used for manufacturing processed products.

The analysis in this chapter will consider raw materials and other material inputs as a broad category encompassing various types of natural resources used as production inputs in the manufacturing process. The report addresses other production inputs, such as energy, chemicals, steel and aluminium sectors in more depth in dedicated chapters.

All manufacturing industries require raw materials, and they enter practically every supply chain. Upstream industries extract, refine and process raw materials while downstream industries further use the processed materials in the manufacturing process.

The development of hi-tech products and environmental applications has led to significant shifts in the demand for raw materials. Whereas in the past certain materials were found only in niche products, currently they have become a crucial component in a number of products, such as indium used in transparent conducting layers which are a component of flat panel televisions and touch screens. Many wind turbines designs use magnets containing rare earth elements, while solar panel production requires among others metals such as silicon, tellurium and indium. Growing demand for those inputs leads to changes in their availability and supply. For example, polysilicon used to be supplied by a very few producers worldwide in the first decade of the 21st century, but in recent years China greatly developed its production capacity to become independent from external imports.

12.3. PLANS AND POLICY DOCUMENTS FOR RAW MATERIALS

Since raw materials cover a broad range of different categories of unprocessed and processed materials, they are also covered by a number of policy documents, including FYPs, Made in China 2025 as well as other sector-specific documents. For facility and guidance, this chapter lists the main materials explicitly mentioned in every document examined as well as highlights different provisions enshrined in other chapters.

As demonstrated below, the plans and other policy documents strictly prescribe every aspect of raw materials production and supply, including provision of detailed target quotas, strict

targets to limit capacity in certain areas and raise capacity in specific fields, lists of specific fostered industries to be further developed, specific support policies, strict control of enterprises including investments, mergers, and central attribution of specific industries to concrete provinces.

The 13th FYPs relevant for raw materials include, but are not limited to:[927]

- Mineral resources development plan 2016-2020;
- Non-ferrous metal industry development plan 2016-2020;
- Construction material industry development plan 2016-2020;
- Land resources development plan 2016-2020;
- Light industry development plan 2016-2020;
- Forestry development plan 2016-2020;
- Textile industry development plan 2016-2020.

12.3.1. FIVE YEAR PLANS FOR DIFFERENT INDUSTRIES AT NATIONAL LEVEL

12.3.1.1. 13TH FYP FOR MINERAL RESOURCES

The following raw materials are, among others, mentioned in the 13th FYP for Mineral Resources:

- Aluminium
- Antimony
- Asbestos
- Barite
- Bauxite
- Bentonite
- Blue asbestos
- Boron (B2O3)
- Chromium
- Clay used for bricks
- Coal
- Coalbed gas
- Cobalt
- Copper
- Copper ore
- Crystalline graphite
- Fluorite (CaF2)
- Gold
- Graphite (crystalline /
- Natural gas
- Nickel
- Niobium-tantalum
- Oil and gas
- Oil sand
- Oil shale
- Petroleum
- Phosphate rock
- Phosphorus (underground mining / opencast mining)
- Phosphorus ore
- Potassium salt
- Pyrite
- Quartz or quartz sand used in glass and ceramics industry
- Quartz sand used in metallurgy and cement
- Rare earths
- Rock salt
- Shale gas
- Silver ore
- Stone material used for construction

[927] Other relevant documents include for instance Made in China 2025 (see Chapter 4.2.3).

cryptocrystalline)

- Gypsum
- Hafnium
- Iron
- Kaolin
- Lead
- Limestone (Cement / other)
- Lithium
- Manganese
- Mica
- Molybdenum
- Stone material used for ornamental purposes
- Sulphur
- Talc
- Tin
- Titanium
- Tungsten
- Uranium
- Vanadium
- Zinc
- Zirconium

Main features of the plan

The 13th FYP for Mineral Resources underlines the importance of the mining sector and security of supply of minerals for industry. According to the plan, since 2008 China undertook major investments into geological surveys (RMB 800 billion), fixed asset investment in the mining sector was more than RMB 9 trillion, and ore output equalled more than 70 billion tonnes.[928]

The plan identifies a number of problems in the sector: '*government interventions in resource allocation are still relatively numerous, market principles applicable to mining rights are not comprehensive, the modern mining market system is not yet complete* […]'.[929]

Governmental control over industry in general

The plan concerns a large number of minerals, with a particular focus on the 24 minerals identified as strategic:

Energy minerals:	petroleum, natural gas, shale gas, coal, coalbed gas, uranium,
Metal minerals:	iron, chromium, copper, aluminium, gold, nickel, tungsten, tin, molybdenum, antimony, cobalt, lithium, rare earth, zirconium,
Non-metal minerals:	phosphorus, potassium salt, crystalline graphite, fluorite.

Those strategic minerals are '*key elements of the mineral resources macro-control, supervision and management*'.[930] Furthermore, the plan mentions the role of governmental decision-making on the sector's development.

[928] 13th FYP for Mineral Resources, Section I-1.
[929] Ibid., Section I-2.
[930] Ibid., Section III-1.

The plan envisages strict entry conditions into mining exploitation, which should take into account the minimum required exploitation scale for mining facilities' and the efficiency of mineral resource exploitation and use. Large mines with low mining activity as well as various mining activities within one single mine should be strictly prohibited, as well as mines not meeting efficiency requirements set out in the plan.[931]

Regulation/schemes for individual minerals

The plan includes a number of detailed provisions with regard to different mineral groups. The provisions listed below are the most important examples of measures which have an impact on the supply side: [932]

Natural gas
Expand survey and exploitation activities; expand the scale of production;

Coal
Control the volume of exploited coal resources; solve production overcapacities; implement structural adjustments; control coal resource exploitation in the central and north-eastern part of the country; optimise exploitation in the western part of the country; no new coal mine with a yearly production of less than 300 000 tonnes should be allowed; dismantling of small mines with safety issues; withdrawal of mines producing less than 300 000 tonnes; encourage restructuring and mergers of coal enterprises as well as resource pooling; foster the emergence of large-sized coal enterprise groups, reduce the number of coal mines to 6 000 by 2020;

Uranium ore (sandstone uranium, uranium ore, hard rock uranium ore)
Intensify exploration of sandstone uranium and discover 20-25 new uranium ore production sites in the Ordos, Yili, Erlian, Songliao, Tuha and Bayin-Gobi basins; strengthen mineral surveys and consolidate hard rock uranium ore resource bases in Jiangxi Xiangshan, Guangdong Zhuguang Mountain, Guangxi Miaoer Mountain; etc.;

Coalbed gas
Continue to implement the Chinese central fiscal subsidy policy for the exploitation and use of coal-bed gas; foster large-scale exploitation in 12 coalbed gas areas planned at the national level such as Shanxi Baode; set up coalbed gas industrialization bases in Qinshui Basin and on the eastern edge of the Ordos basin; support coal mining right holders to increase the number of minerals exploited and to proceed to the comprehensive exploitation of coalbed gas;

Shale gas
Strengthen shale gas surveys, evaluations and explorations; develop exploration and exploitation demonstration sites; keep on implementing subsidies policies for shale gas development and use; foster low-cost and large-scale development;

[931] Ibid., Section V-2.
[932] Ibid., Section IV-2.

Oil shale (oil shale, oil sand)
Strengthen oil shale and oil sand exploration in Songliao, Ordos, Qaidam and Jungar basins; develop demonstration sites; foster core technologies with indigenous IPR;

Geothermal resources (geothermal water, dry hot rock)
Foster geothermal resource investigations as well as demonstration projects for exploitation and use in the south-eastern coastal area, Beijing-Tianjin-Hebei and western-southern part of the country; strengthen monitoring and management of exploitation and use; implement support policies;

Iron ore
Stabilize the domestic supply capacity, set up iron ore bases and ensure guidance of local resources to concentrate them towards large-sized mining groups in Anben, Jidong, Panxi, Baobai, Xinzhou-Luliang, Ningwu and Lucong; build a number of new large-sized mines; promote a fair tax burden; reduce the burden on iron ore enterprises; not build new open air iron ore mines with a yearly production below 200 000 tonnes or underground iron ore mines with a yearly production below 100 000 tonnes;

Manganese
Strenghten exploration and exploitation in Southwest Guangxi and Huanan Yongzhou; do not build new mines with a yearly production below 50 000 tonnes;

Copper
Consolidate the existing copper and nickel production bases in the Yangzi River, Inner Mongolia (Wunugetu Mountain), Gansu (Jinchuan), Xinjiang; build copper production groups; stabilize the copper ore production capacity at 600 000-700 000 tonnes per year; strive to raise the copper ore supply capacity by 80 000-100 000 tonnes per year; build new copper and nickel mines in Qinghai and other bases;

Bauxite
Encourage large-size mining enterprises to participate in resource exploitation and integration in Jinzhong, north-west Henan, Southwest Guangxi and north-central Guizhou; strive to develop new supply capacities of 20-30 million tonnes per year;

Nickel
Maintain the nickel ore production capacity at 90 000-100 000 tonnes per year;

Lead and zinc
Encourage the concentration of resources towards backbone enterprises in south Xinjiang, south Gansu, south Hunan – north Guandong, central Yunnan-south Sichuan, south-west Yunnan in priority; strive to control lead and zinc mining capacity to within, respectively, 3 500 000 tonnes per year and 6 250 000 tonnes per year by 2020;

Molybdenum
Build bases in west Henan, Shaanxi (Weinan) and Heilongjiang (Yichun); control new production capacity increases;

Tungsten, tin, antimony
Consolidate tungsten resource bases in south Jiangxi, Hunan (Chenzhou); stabilize the scale of mining operations; raise the mining and supply capacity of tin and antimony in the resource bases of south-east Yunnan, Guangxi (Hechi), Hunan (Anhua, Lengshuijiang) etc.; the overall mining volume of tungsten ore shall be controlled to within 120 000 tonnes per year;

Gold, silver, other precious metals
Strengthen exploration of precious metal minerals, build a resource base in Shandong (Zhaoyuan-Laizhou), further raise production levels; encourage enterprises to proceed to mergers and resource integration in accordance with market rules and laws; ensure the emergence of a number of large size yellow gold enterprise groups having a core competitiveness; do not build new underground yellow gold mines of a size below 30 000 tonnes and or new open air yellow gold mines of a size below 60 000 tonnes;

Phosphorus
Stabilise the supply in important mineral resources used in agriculture such as phosphorus, sulphur and potassium, in accordance with the food security strategy; set up resource bases in central Yunnan, Guizhou (Kaiyang-Wengfu), Hubei Yixing; maintain the overall volume of mined phosphorus rock at 150 million tonnes per year approximately; guarantee the supply capacity in phosphorus fertilisers;

Sulphur
Strengthen the comprehensive recycling of associated sulphur and sulphur resources contained in oil and gas; maintain the production volume at 18 million tonnes per year;

Potassium
Consolidate potassium salt bases in Qinghai Chaerhan and Xinjiang Lopnur; maintain the rate of domestic self-sufficiency at 55%-60%; adequately control the potassium salt mining intensity and new increases of production capacities;

Non-metal minerals (bentonite, attapulgite, diatomaceous earth, sepiolite clay, strontium, lithium, boron, sodium, fluorite, kaolin, talc, barite, mineral wallostonite)
Improve the comprehensive recovery level for strontium, lithium, boron, sodium etc.; strengthen guidance, supervision and management for bentonite in Liaoning (Jianping), Xinjiang (Xiazijie), Inner Mongolia (Chifeng), attapulgite clay in Jiangsu (Xuyi), Anhui (Mingguang), Gansu (Linze), diatomaceous earth in Jilin (Linjiang and Changbai) and sepiolite clay and other high quality clay in Hunan (Xiangtai); encourage growth and green exploitation of fluorite, boron, kaolin, talc, barite, mineral wollastonite and other materials as well as the integrated development of the upstream and downstream industry sectors;

Construction materials (limestone cement, glass silica, sandstone, clay)
Control the size of the development and use of limestone cement and glass silica materials; give guidance so as to ensure mining concentration, large-size mining and green mining; set a higher threshold for scale and intensification for market entry;

Rare earths
Set up 6 rare earth resource bases in Inner Mongolia (Baotou), Sichuan (Liangshan), Jiangxi (Ganzhou); consolidate the exploration, exploitation and resource allocation patterns as led by large-size rare earth enterprise groups; keep implementing a mining volume control system; establish a dynamic balanced system of rare earth mining and consumption reserves and new reserves; by 2020, the overall mining volume shall be controlled at 140 000 tonnes per year;

Rare and scattered metal resources (niobium-tantalum, zirconium-hafnium, tungsten-tin, copper, lead-zinc, aluminium, coal)
Increase the level of financial support; increase the level of geological surveys;

Lithium energy metal minerals (lithium pyroxene, lithium ore, lithium mica)
Foster the exploration and exploitation of lithium pyroxene in Sichuan (Ganzi), lithium ore in Xinjiang (Altay), lithium mica in Jiangxi (Yichun); set up new-type energy resource bases for lithium ore in Sichuan (Jiajika);

Graphite
Create a number of graphite resource bases; ensure the coordinated development of the upstream resource exploitation with the downstream industries;

Toolbox

As indicated above (see in particular Chapter 4.2.8), the intervention of the government related to individual minerals and their supply on the market is achieved via a number of instruments, including:

Quantitative output binding and forecast indicators
As a general rule, the plan envisages ‘strict control of mining rights and the scale of mining activities’. The plan sets out forecast indicators and binding indicators for yearly mining volumes for different types of minerals. Binding indicators are set for tungsten rock, with an output defined at 120 000 tonnes and for rare earths, with an output of 140 000 tonnes. The remaining forecast indicators are formally non-binding; however since they are translated into provincial plans as well as mining permits, they seem to have an impact on the quantities mined. The plan itself sets the goal to ‘improve the control and management of yearly volume indicators’. Forecast indicators are set for: crude oil, natural gas, shale gas, raw coal, coalbed gas, iron ore, manganese ore, copper ore, bauxite ore, nickel ore, lead ore, zinc ore, molybdenum ore, antimony ore, tin ore, gold ore, crystalline graphite and phosphate rock.[933]

[933] Ibid., Table 2.

Creation of mines with a minimum output

As indicated above, in the case of certain minerals (coal, gold, silver and other precious metals), only mines meeting the minimum output requirements can be created or can remain on the market.[934]

Governmental control over capacity

Apart from setting mining targets, the Plan lays down that there should be reasonable coordination and control of exploitation of minerals for which China has a traditional advantage. Furthermore, in case of production overcapacities, the plan provides for strict control of new production capacity increases, elimination of obsolete production capacities and withdrawal of production overcapacities. The Plan envisages to '*limit the mining and exploitation of molybdenum and other minerals showing production overcapacities'*.[935]

Governmental interventions into the structure of enterprises

The plan sets out the target of medium-large sized mines accounting for more than 12% of all mines. For iron, manganese, copper, aluminium, nickel, lead, zinc, tungsten, tin, antimony, gold and silver the plan envisages to ensure enterprise concentration and development of large and medium sized mines competitive on the market.[936]

The Plan sets out that the government will support the reform of SOEs, actively encourage the development of mixed ownership enterprises and foster mining sector market actors which are competitive on the market.[937]

Security of supply

The plan sets out a policy to ensure a secure and stable mineral resource supply. Detailed steps include consolidation of domestic secure supply capacities of iron, copper, bauxite, potassium salt and other strategic minerals, delineation of 267 mining areas at the national level and 28 mining areas of major added value.[938]

With regard to iron, manganese, copper, aluminium, nickel, lead, zinc, tungsten, tin, antimony, gold and silver the plan envisages stabilising the level of domestic effective supplies. As regards 50 mineral categories that are essential to support and maintain China's strategic emerging industries, China shall as a priority strengthen the reasonable exploitation and effective protection of rare earths, rare minerals, scattered minerals, graphite, lithium etc. that have good resource bases, a huge market potential and that are competitive on international markets.[939]

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[934] Ibid., Section IV-2.
[935] Ibid., Section V-1.
[936] Ibid., Section II-3.
[937] Ibid., See Section III-1.
[938] Non-ferrous metals 13th FYP, Section III-3.
[939] Ibid., Section IV-2.

The Plan mentions fostering of domestic surveys and exploitation of oil, gas, iron, copper, bauxite, potassium salt and other large-sized mineral areas. Furthermore it envisages strengthened international cooperation in the mining sector.[940]

Central control of geographical industry distribution in China

The plan sets out a number of goals for different regions of China, including, among others, transferring industries located in the Central and Eastern parts of the country to the west, ensuring governmental guidance of the coordinated development of resource advantages along the BRI project, and controlling the resource exploitation intensity in the Beijing-Tianjin-Hebei region.[941]

Industry support measures

The plan sets out a target to lower administrative and approval costs for mining enterprises, reduce the burden on enterprises, and strengthen the management of preferential tax policies applicable to mineral resources.

The specific provisions of the Plan hinting at governmental (financial) support include '*actively support the exploration and exploitation of oil and gas at sea'* and for coordinated exploitation of multiple minerals: '*increase policy support, [...] grant tax reduction and exemption to mining companies obviously succeeding in ensuring comprehensive exploration and mining*'.[942]

Governmental interventions into private initiatives

The Plan confirms that the government will have a role in private initiatives. Those initiatives include for example the following: '[China shall] *actively guide non-governmental capital to enter the sector of uranium ore exploitation*'; [...] '*encourage and guide non-governmental capital investments towards geological prospection*'; [...] '*encourage and give guidance to commercial exploration investments*'.[943]

At the central authorities' level, the below regulations have been promulgated since November 2016 to implement the National Plan for Mineral Resources (2016-2020):

- The Opinion of Ministry of Land and Resources on Promoting Comprehensive Saving and Efficient Utilisation of Mineral Resources (13 December 2016);
- Trial Minimum requirements on 'three rates' for the proper exploitation and utilisation of mineral resources' including lithium, strontium, barite, limestone, magnesite and boron (23 December 2016);
- Catalogue for the Promotion of Advanced Technologies for Mineral Resources Saving and Comprehensive Utilisation, issued by MLR (27 December 2016);

[940] Ibid., Section IV-1.
[941] Ibis., Table 10.
[942] Ibid., Section IV-5.
[943] Ibid., Section III-1.

- The Work Plan for the Investigation and Assessment System of Mineral Resources Development and Utilisation jointly issued by MLR, NDRC, MIIT, MOF, and NEB (28 December 2016);

- Pilot Scheme for Integrating the Proven Reserves of Mineral Resources into the Unified Registration of Natural Resources, issued by MLR (15 March 2017).

12.3.1.2. 13TH FYP FOR THE NON-FERROUS METALS INDUSTRY

Raw materials mentioned in the 13th FYP for the Non-ferrous Metal Industry (2016-2020):

- aluminium
- antimony
- bauxite
- copper
- lead
- magnesium
- mercury
- nickel
- tin
- titanium
- zinc
- rare metals:
  - cobalt
  - gallium
  - germanium
  - indium
  - lithium
  - molybdenum
  - tungsten
  - yellow gold
  - zirconium

Main features of the plan having an impact on the supply side

The plan 13th FYP for Non-ferrous Metal Industry underlines that '*the 12th FYP's objectives were basically reached, the sector's development maintained a stable trend'.*[944] Non-ferrous metal industry enterprises above a certain size achieved an operational income of RMB 5 700 billion, achieving an average growth rate of 11.6% over the 12th FYP time. The overall profit of those enterprises was RMB 179.9 billion. The Plan identifies some problems, including production overcapacities; lack of competitiveness (for example in the case of the electrolytic aluminium sector): '*the industry concentration level is too low and enterprises are weak; [...]; there are disorders as regards market competition'*. Furthermore, '*mineral product prices have sharply gone down and domestic mining enterprises have operational difficulties everywhere; […] mismatches between effective demand and effective supply continue to exist'*.[945]

The provisions of the Plan ensure strong presence of the State in the non-ferrous metals industry and also impact the supply level. Those provisions include, for example, the goal of increasing supply of raw materials, change of industry location by encouraging transfers, encouraging a number of products, strict control of overcapacity, various extensive support

[944] 13th FYP for the Non-ferrous Metal Industry., Section I-1.
[945] Ibid., Sections I-2 and II-1.

measures (financial and otherwise) including supporting international cooperation by financial support. A detailed list of interventionist provisions is included below.

The plan stipulates that the demand for non-ferrous metals should grow as a result of the development of the following strategic emerging industries: '*light transport equipment, transformation of power grids in rural areas, a new generation of IT industry, new energy cars, high-end manufacturing equipment, energy saving and environmental protection'.* However, the plan projects that '*except for new energy metals such as lithium, cobalt etc. as well as for magnesium for which the demand shall keep growing quickly*', the demand for other metals will not grow: '*copper, aluminium and other major products shall show a clear slowdown in consumption growth; lead shall basically remain at the same consumption level, zinc might reach a consumption peak at the end of the 13th Five-Year-Plan'.* The Plan provides a detailed 2020 forecast of the consumption / demand for different non-ferrous metals (in 10 000 tonnes): refined copper: 1 350, raw aluminium 4 000, lead 450, zinc 730, magnesium 75 and yellow gold 1 200.[946]

Note that many of the areas, for which the plan makes consumption forecasts, are regulated in other plans. For instance the products covered by Made in China 2025 and the SEI list include goods which utilise non-ferrous metals (see for example Section 12.3.2 on new material industry).

General industry development goals

The plan sets the following general development goals: 8% yearly growth of the industry's added value; sales of deep processing products should take up 40% of the main business income of the whole industry; major enterprises should invest 1% of the operational business income into R&D.[947] The plan also sets out a number of green development targets.

Central control of geographical industry distribution in China

The Plan envisages a number of provisions with regard to geographical distribution of different industries:

> *unreasonable production capacities should be transferred towards regions having an advantage in terms of resource, energy and environmental bearing capacity; […] smelting enterprises that are difficult to conciliate with the urban development needs, whose transformation is difficult and whose competitiveness is weak, should be transformed/converted or should withdraw; […] enterprises meeting the conditions for being transferred will be supported to withdraw from cities and resettle in industry parks.[…] Enterprises located in poor regions or less developed regions should be encouraged to develop rough processing.*[948]

[946] Ibid., Section II-2, Table 2.
[947] Ibid., Section III-3, Table 3.
[948] Ibid., Section IV-2.

[…]enterprises specialised in the fine and deep processing of key non-ferrous metals and located in China's Eastern, Southern and North-Eastern parts shall change from focusing on size expansion to giving full play to equipment efficiency and improving product quality […] and expand towards spare parts manufacturing, semi-finished products, manufactured products and production services". China shall "support the setting up of concentration areas for high-end deep-processing industries such as 'China's rare metals valley' in Ganzhou, new materials in Ningbo, rare metals in Xi'An and Kunming, hard alloys in Zhuzhou, rare metals in Baoji-Xi'An etc. […]

set up demonstration bases for greener, expanding and value-increasing uses of renewable metals in regions such as the Pearl-River Delta, the Yangzi Delta, and the Bohai Sea's periphery.[949]

The Plan furthermore lists a number of industry factories which should be transferred from cities into industry parks, for example the Hunan Zhuzhou Smelting Plant, the Guangdong Shaoguan Smelting Plant, Zhuzhou Hard Alloy Plant, etc.[950]

Security of supply

In order to ensure security of resources, the plan envisages among others development of resource exploration and exploitation, improvement of '*the security of resources such as copper, aluminium, nickel etc. for which there is a shortage*'[951] and '*improvement of the world allocation system for major non-ferrous metal resources*'.[952]

The plan sets out the target to:

support strong enterprise groups or alliances to orderly proceed to resource exploration, exploitation and conclude cooperations in China and abroad; set up diversified mineral resource supply systems; foster the integration of domestic mines at regional level; implement exploitation above a certain size as well as intensive use; optimise production and operational environment for backbone mining enterprises; increase capacities to preserve resource security and increase the level of exploitation and use.

Furthermore '*over the 13th FYP period of time, the new domestic resource reserves shall reach 8 million tonnes of copper, 600 million tonnes of bauxite, 20 million tonnes of lead, 30 million tonnes of zinc, 1 million tonnes of tungsten ore (W03), 700 000 tonnes of tin, 800 000 tonnes of antimony, 800 000 tonnes of nickel and 6 000 tonnes of yellow gold*'.[953]

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[949] Ibid.
[950] Ibid., Section IV-2, Table 5.
[951] Ibid., Section III-3.
[952] Ibid.
[953] Ibid., Section IV-5.

In order to increase the resource supply capacity, the Plan envisages to '*encourage and speed up exploration and exploitation of copper, aluminium, nickel and other scarce minerals and of gold, silver and other precious metals*'.[954]

The plan states that '*the capacity to provide aluminium materials for aviation, material for electronics, power batteries materials, high-performance hard alloys, etc. should exceed 70% of the demand and basically cover the demand of high-end equipment, of the new generation of IT technologies etc.*'.[955]

With regard to metals in functional materials, the Plan envisages to '*take into account the demand of marine engineering, nuclear power and other high-end equipment manufacturing sectors; strongly develop products such as:*

- *high-performance anti-corrosion copper alloys,*
- *large-diameter, high anti-corrosion copper alloy tube materials,*
- *low-expansion, high effort-resistance copper alloys,*
- *high-temperature anticorrosion nickel-based alloys,*
- *carbonyl nickel,*
- *carbonyl nickel iron powder,*
- *magnesium-based hydrogen storage materials,*
- *gold-based nano-catalysts and powder materials;* […]

meet the domestic demand.'[956]

Governmental control over capacity

The plan provides for strict governmental control of production capacity in the field of non-ferrous metals. According to the plan, China shall '*promote the withdrawal of low-efficiency production capacities',* '*strictly control newly established smelting facilities for copper, electrolytic aluminium, lead, zinc, magnesium etc.; encourage outdated lead and zinc smelting capacities to proceed to technological reform;*" as well as "*duly control the expansion of yellow gold smelting capacities'*.[957] Furthermore, the Plan sets the goal to '*improve production restrictions and value protection mechanisms applicable to tungsten etc.; [and] reasonably adjust and control mining volume control indicators for tungsten'*.[958] With regard to rare metals the plan sets out to '*strengthen supervision based on overall control indicators applicable to key rare metals and apply sanctions in case of breach*'.[959]

Governmental goals for international cooperation

China will '*make arrangements to use both domestic and foreign resources, support strong enterprise groups or alliances to orderly proceed to resource exploration, exploitation and conclude cooperations in China and abroad,* […], *develop win-win exploitation and*

[954] Ibid.
[955] Ibid., Section III-3.
[956] Ibid., Section IV-3.
[957] Ibid., Section IV-2.
[958] Ibid., Section IV-5.
[959] Ibid., Section V-1.

investment cooperations with relevant countries and regions; steadily foster the building of production bases abroad for copper, aluminium, nickel, rare and precious metals and other mineral resources'.[960]

Furthermore, the plan envisages to:

> *encourage strong enterprise groups to set up smelting projects in regions where resources are abundant such as central and southern Africa, Central Asia, South-East Asia, Western Asia, Middle-East, South America etc., as well as to set up deep processing projects in countries and regions where the non-ferrous metal consumption potential is relatively significant; […]; develop a reservoir of international production capacities cooperation projects; […]; build and develop economic cooperation areas abroad; […]; support domestic enterprises to participate in international cooperation plans in the field of new materials, smart manufacturing and other large-size science and technology cooperation; develop overseas cooperation and investments; […]; encourage foreign enterprise and research institutes to set up R&D centres and production bases for non-ferrous metal new materials and smart manufacturing on the Chinese territory.*[961]

In order to achieve the above goals, the Plan envisages to '*increase the financial support to eligible major international cooperation programmes*'.[962]

Governmental interventions into the structure of enterprises

China sets out specific goals with regard to the structure of the non-ferrous metals industry. China will support enterprise mergers and restructuring, following the government and policy guidance. China will '*encourage non-ferrous metal enterprises, develop alliances and restructurings withing upstream and downstream industries, as well as across industries* […], *significantly raise the level of concentration in the sector,* […],*-set up an integrated upstream and downstream industry chain, enhance enterprises' strengths and competitiveness*'.[963] China wants furthermore to '*reduce the number of small and medium sized enterprises*'[964] and will '*encourage enterprises to adjust their own development strategy and to take initiatives to reduce overcapacities and low-efficiency production capacities*'.[965]

Governmental goals for the development of enterprises

According to the Plan, China shall:

> *guide enterprises so that they speed up innovation, stabilise and improve product quality; support enterprises so that they introduce production-line monitoring,*

[960] Ibid., Section IV-5.
[961] Ibid., Section IV-8.
[962] Ibid., Section V-5.
[963] Ibid., Section IV-2.
[964] Ibid.
[965] Ibid.

> *smart manufacturing, and logistics systems etc.; effectively increase the variety of products supplied; […] consider enterprises having an established brand reputation and international competitiveness as pillars; foster a number of leading enterprises and non-ferrous metals fine products, with optimal quality and prices as well as improved marketing services.*[966]

Further targets include *'utilisation rate of the electrolytic aluminium production capacity should exceed 80%*',[967] implementation of '*the smooth substitution of old mines by new ones'*.[968] and '*speeding up the withdrawal of poorly efficient enterprises*'.[969]

Specific production targets

China sets out a target to '*focus on the development of high performance light alloy materials, non-ferrous metals for electronic materials, non-ferrous metals for new energy materials and rare metals materials for deep processing; raise material quality homogeneity; lower cost and raise the mid and high range effective supply capacity and supply level'*.[970]

The Plan sets out very detailed and technical development goals for high performance alloy materials, non-ferrous metals in electronic materials and new energy materials. With regard to high performance alloy materials:

> *Focus on large-size equipment and high-end manufacturing sectors such as large-sized aircrafts, passenger cars, high-speed trains, shipbuilding, marine engineering etc.; speed up the implementation of smelting and casting of large standard aluminium-lithium alloy ingots, high-speed air-cushion heat treatment systems for high-precision thin strips, large volume manufacturing of high-precision and wide strips made of magnesium, titanium alloy extrusion processing and on-the-production-line conditioning, large-size titanium alloy materials, 3D printing powder. By 2020, ensure a stable supply of high-performance light alloys used in aviation, passenger cars and freight transport vehicles, titanium and aluminium alloy materials used in marine engineering etc., continuously raise the international competitiveness.* [971]

A detailed list of materials follows in table 6 of the Plan.

For electronic materials, the plan sets out the goal to '*speed up the development of large-sized silicon mono-crystalline polished wafers, ultra-large high-purity metal target materials, substrate and packaging materials for high-power microwave and laser devices, infrared detection and imaging materials, vacuum electronics etc.*' as well as to '*raise the supply level*

[966] Ibid., Section IV-1.
[967] Ibid., Section III-3.
[968] Ibid., Section IV-5.
[969] Ibid., Section V-5.
[970] Ibid., Section IV-3.
[971] Ibid.

of high-end non-ferrous metals for electronic materials'.[972] A detailed list of materials follows in Table 7 of the Plan.

For non-ferrous metals in new energy materials, the Plan envisages to '*develop in priority cathode materials for high-capacity and long-duration energy storage batteries, anode materials, high-performance copper foils and aluminium foils, as well as low-cost high-quality battery-grade lithium carbonate, ternary precursors etc.'*.[973] A detailed list of specific materials follows in Table 8.

With regard to rare metal materials, the specific goals include: '*focus on the demand of sectors such as high-end manufacturing equipment, strategic emerging industries, and other national large projects etc.; develop in priority precision hard alloys and deep processing materials, large-sized tungsten and molybdenum panels and foils, nuclear-grade zirconium, hafnium and beryllium; speed up the technological improvements; raise product quality; raise effective supply'*.[974] A detailed list of development priorities follows in Table 9.

Priority projects for resource exploitation provided in the plan include mine building projects, copper and cobalt mines, lead, zinc, nickel and gold mines, bauxite mines and alumina. Table 11 includes a detailed list of mine building projects and mines which should be supported, including for example:

> *Copper and cobalt mines: Support the establishment of development bases such as: the Xinjiang Altay area copper polymetallic mine; the Yunnan Diqing Pulang Copper mine; the Yunnan Copper enterprise Liangshan Hongni copper mine; Tibet Yulong Copper Mine Phase II; Hubei Tonglushan - Tongshankou Copper polymetallic mines; Heilongjiang Nenjiang area copper Mine; Consider investments in copper and cobalt resources in South America, Africa and neighbouring countries and regions as bases, and keep on promoting projects under construction and planned projects.; […]; Others: Speed up the establishment of development bases such as: the south-eastern Yunnan - tin mines; Guangxi Hechi area tin, antimony, polymetallic mines; Hunan - Lengshuijiang area and Anhua area as well as Guangxi Hechi Nandan antimony mines; Hunan Yongzhou, Daoxian, Xiangyuan lithium, rubidium and cesium mines; Actively promote resource exploitation projects in regions and countries rich in lithium, tin, antimony and other resources.*[975]

<u>Industry support measures</u>

China shall '*support enterprises through mergers and restructuring, debt restructuring, production upgrade and other tools'*;[976] '*support energy-intensive industries to use the local*

[972] Ibid.
[973] Ibid.
[974] Ibid.
[975] Ibid., Section IV-5.
[976] Ibid., Section IV-2.

power grid's renewable energy sources';[977] '*attract and support enterprises to develop comprehensive large-sized projects;* […] *foster enterprises upstream and downstream of the industry chain, foster advanced equipment, technology, design, construction and engineering, standards, services and other industry chain outputs'*.[978] Furthermore, the Plan envisages to '*develop new types of subsidies granted after technological achievement; encourage enterprises to innovate and conquer new markets*; […]; *increase the SOEs' vitality'*.[979] There are also provisions to '*support the development of non-ferrous metal new materials*'.[980]

The plan provides for measures lowering the costs of production, including reducing electricity cost of the non-ferrous metal industry: '*support non-ferrous metal enterprises complying with the sectors' regulations and conditions, energy consumption and environmental protection standards to develop direct electrical supply deals; support electrical power users to negotiate lower grid utilisation charges and back up capacity charges with electrical grid enterprises*; […]; *reduce the cost of electrical power utilisation; improve the enterprises' economic benefits'*.[981]

The Plan also sets out a number of fiscal and tax policy support measures, including:

> *strengthen the connexions between fiscal, tax, financial, trade and the industry policy; support connexions between banks and enterprises as well and cooperation between the production and the financial sectors; provided risks remain controllable and business remains sustainable, expand the financial support to backbone enterprises that continuously comply with regulations and conditions, environmental protection and safe production standards, that have market perspectives and that are operationally efficient; fully use the already existing funding channels; encourage local governments and private capital to expand investments; speed up the reform and upgrade of the non-ferrous metal industry; implement preferential tax policies applicable to mining and tax policies applicable to mergers and restructurings.*

[977] Ibid., Section IV-4.
[978] Ibid., Section IV-8.
[979] Ibid., Section V-3.
[980] Ibid., Section V-5.
[981] Ibid., Section V-4.

12.3.1.3. 13TH FYP FOR THE CONSTRUCTION MATERIALS INDUSTRY

Raw materials mentioned in the 13th FYP for the Construction Material Industry (2016-2020) include:

- Agricultural and forestry residues
- Artificial crystals
- Attapulgite clay
- Basalt fibres
- Bentonite
- Carbon fibres
- Cement
- Chemical construction materials
- Composite materials
- Diatomaceous earth
- Diatomite
- Dry cement clinker
- Fire-resistance materials
- Flat glass
- Glass
- Glass fibres
- Graphene
- Graphite
- Green construction materials
- High-performance fibres
- Industrial ceramics
- Insulating materials
- Kaolin
- Lead-free piezoelectric ceramics
- Magnesite
- Mica
- Mineral functional materials
- Mineral materials
- Non-metal minerals
- Non-organic fibres
- Organic functional materials
- Ornamental materials
- Quartz
- Ready-made mortar
- Sand aggregate and other basic raw materials
- Sanitary ceramic
- Sepiolite
- Stone material
- Structural ceramics based on silicon nitride, silicon carbide, zirconium oxide,
- Talc
- Transparent ceramics
- Wall materials
- Waterproof materials
- Wollastonite

Main features of the plan

As guiding concepts for the development of the construction industry, the plan sets out the goal of reducing overcapacities, expanding the sectors of advanced non-organic non-metal materials, composite materials as well as construction industry related services, optimize the allocation of the main factors, conquer new spaces for development as a means to ensure transition of the construction material industry '*from a large industry to a strong industry*'.[982] The plan furthermore envisages optimisation of the construction sector's structures,

[982] 13th FYP for the Construction Materials, Section III-1.

improvement of the security of supply of key materials, increase in the level of concentration in the industry as well as enhancement of the international competitiveness.[983]

Quantitative development targets

The plan sets out detailed targets with regard to the development of the construction industry, for example '*the share of the cement-based material related business income in the cement and cement related manufactured products' sector*' should be raised to above 60% in 2020 from 53% in 2015, the deep processing rate of flat glass should increase from 40% in 2015 to 60% in 2020. The concentration level of the top ten enterprises producing cement clinker and flat glass is set to be raised from 53% to over 60%. The share of coordinated processing and production lines for cement kilns should increase from around 7% to 15% in 2020.[984]

Governmental control over production capacity

Furthermore, the plan includes a provision to eliminate sub-standard production capacities, including withdrawal of production capacities that after reform and adjustment still do not comply with mandatory standards as to environmental protection, energy consumption, safety, quality etc.[985] The plan envisages a number of actions to reduce production capacities in traditional construction material sectors, including prohibiting the planning of new facilities building projects and building expansions of production capacities for cement clinker and flat glass (until the end of 2020)[986] and suspension of production capacities exchanges between different enterprises of an effectively controlling shareholder as regards cement clinker and flat glass (by 2017). In order to further tackle the problem of overcapacity, the plan envisages implementation of policies such as differentiated prices, or differentiated price categories for electric power in highly energy consuming sectors, coupled with raising of technological thresholds above which it is possible to benefit from fiscal and tax policies related to the comprehensive use of resources. The plan includes also provisions to impose withdrawals of production capacities lacking competitiveness. With regard to cement and flat glass there are the following provisions: *'continue to improve cement staggered production; support the flat glass sector to develop self-discipline; appropriately restrict production'*.[987]

Detailed production targets

The plan sets out production and detailed development targets for the upgrading and replacement of traditional construction materials including cement, glass, construction and sanitary ceramics, wall materials, fire-resistance materials and chemical construction materials and ornament materials. As an example of the upgrade provisions, the following actions are envisaged for glass: '*Promote double silver and multiple silver coated low-emission glass (Low-E), safety double glazing and other energy saving windows; develop high-end products for transport equipment windshields and windows; develop manufactured*

[983] Ibid., Section III-3.
[984] Ibid., Table 2.
[985] Ibid., Table 3.
[986] Ibid., Section IV-1.
[987] Ibid., Table 3.

products such as high boro-silicate glass, high alumina glass, ultra-thin glass, ultra-white glass and quartz glass'.[988] Similarly, the non-organic non-metal materials such as glass-based materials, industrial ceramics, artificial crystals, high performance fibres and composite materials and graphene and related modified materials are subject to specific development targets. As an example, industrial ceramics should focus on high-temperature structural ceramics based on silicon nitride, silicon carbide, zirconium oxide, new lead-free piezoelectric ceramics, transparent ceramics etc.[989]

Geographical distribution of industries among provinces in China

The plan sets out very detailed directions with regard to the division of industries among different regions. As an example, the northern regions should foster graphene materials, Hebei should raise the glass industry level, standardize and develop the insulating material industry, Shanxi should create industry bases for basalt fibres and fire-resistant materials and Inner Mongolia should rely on the advantage of graphite resources to develop graphite deep processing. Eastern regions should concentrate on other materials: '*Jiangxi* [should] *develop glass fibres and composite materials, ceramics, wollastonite, black talc deep processing industry; Shandong* [should] *develop industrial ceramics, glass processing, graphene, talc processing industry, high-performance fibres and composite materials* [and] *Fujian* [should] *develop and boost the upgrade of ceramics, stone material industries etc*. [and] *optimise and strengthen glass, kaolin deep processing industries'.* The plan includes similarly very specific provisions for other regions of China.[990]

Security of supply

The plan furthermore envisages a number of actions to ensure security of supply of certain crucial raw materials:

> [China shall]
>
> - *speed up the development of advanced non-organic non-metal materials,*
>
> - *ensure the industrialisation and scaling up of key basic materials,*
>
> - *increase the capacity to ensure supply security for key basic materials;*
>
> - *focus on the development of glass-based materials, industrial ceramics, artificial crystals, mineral and organic functional materials, high-performance non-organic fibres and composite materials,*
>
> - *encourage the development of frontier materials such as graphene etc.*[991]

[988] Ibid., Table 4.
[989] Ibid., Section IV-3.
[990] Ibid., Table 5.
[991] Ibid., Section IV-3.

Development of specific industries

The plan envisages development of the following mineral functional materials: graphite, quartz, diatomaceous earth, wollastonite, bentonite, kaolin, sepiolite, attapulgite clay, mica and talc. The key technologies to be fostered in priority include cement, glass, construction and sanitary ceramics, wall materials, high-performance fibres and composite materials, non-metal minerals mining, dressing and deep processing and advanced non-organic non-metal materials.[992]

Governmental control and influence over enterprises

China will furthermore control and influence the enterprises active in the construction industry, for example:

> *guide and support construction materials enterprises in the field of construction and sanitary ceramics, waterproof materials, glass curtain walls, wall materials in parts and roofing materials etc. to carry out service-oriented manufacturing, evolve from providing a single product to providing services and overall solutions, […]*
>
> *guide backbone enterprises in the cement, glass, construction and sanitary ceramics and other sectors to evolve from supplying "material only" towards supplying R&D and design, procurement and logistics, marketing and financing, construction and maintenance, technological support and other integrated services, […]*
>
> *ensure the evolution of traditional business; […] raise the level of coordination within the supply chain.*[993]

Furthermore, China will support domestic construction companies to participate in international market investments and business via mergers, restructurings and equity investments and 'guide' foreign capital to cooperate with domestic companies in the field of mining and non-metal minerals.[994]

Industry support measures

The Plan sets out a number of provisions on the improvement of support policies, including the following: *'support enterprises to proceed to a technological transformation; strengthen the connexions between the industry policy and the fiscal and tax policy, financial policy, price policy, energy policy, environmental policy and other relevant policies'*. And *'support [*to*] all types of mergers and restructurings of construction material enterprises by providing merger/acquisition loans, merger/acquisition securities, direct funding etc.'* will be granted by the central government.

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[992] Ibid., Table 8.
[993] Ibid., Section IV-2..
[994] Ibid., Section IV-5.

12.3.1.4. 13TH FYP FOR THE TEXTILE INDUSTRY

The 13 FYP for Textile Industry (2016-2020) concerns cotton, silk, wool and chemical fibres as raw materials.

Main features of the plan

With regard to cotton, the plan sets out the policy to: '*improve the management of cotton import quotas; increase the utilisation rate of quotas; meet the textile enterprises' demand for high-quality cotton; establish a link between the reserve cotton's floor price and the domestic and foreign spot market prices, speed up reserve cotton absorption; keep on improving the cotton price formation mechanism, the cotton target price subsidy policy and the cotton trade remedy measures*'.[995] There is also support granted to the silk sector: '*Support the silk sector to expand automation as regards silk reeling machines, digital weaving, digital printing technology applications*'.[996] To strengthen security of supply, the plan also sets out provisions concerning international cooperation: '*encourage leading backbone enterprises to proceed to transnational raw material production and processing, to set up overseas raw material bases for cotton, wool, chemical fibres, etc. so as to ensure a stable raw material supply*.'[997]

12.3.1.5. 13TH FYP FOR FORESTRY

The 13th FYP for Forestry (2016-2020) concerns wood as a raw material.

Main features of the plan concerning wood supply

> *Speed up the establishment of national reserve forests*
>
> *In southern provinces where water, soil, light and heat conditions are satisfactory as well as in other appropriate areas […]: use governmental development funding, policy funding and commercial funding channels, improve public finance related discounts as incentives, foster cooperation mechanisms between governmental and private capital, encourage private capital to participate in reserve forest investments, exploitation and management, so as to speed up the establishment of national reserve forests.*
>
> *[…]*
>
> *In the key state-owned forest area in northeastern region as well as in Inner Mongolia:strengthen the establishment of forest strategic reserves and bases.*

[995] See 13th FYP for Textile Industry Development, Section V-3
[996] Ibid., Section IV-3
[997] Ibid., Section III-5

By 2020, the national reserve forests shall cover 210 million mu [1 mu= 667 m^2] which shall, after they have been fully established, generate a yearly increase of timber supply capacity of more than 95 million m3.[998]

12.3.2. PLANS – PROVINCIAL LEVEL: HEBEI 2016 NEW MATERIAL INDUSTRY DEVELOPMENT PLAN

As demonstrated in Chapter 3, the national plans are translated into more detailed plans on the provincial and municipal level.

The Hebei 2016 New Material Industry Development Promotion Plan[999] ('Hebei New Material Industry Plan' or 'Plan') seems to be a provincial implementation of the Guide for the Development of the New Materials Industry issued at the national level,[1000] which in turn refers to Made in China 2025. The provisions of this Plan demonstrate that the Chinese intervention into different types of inputs goes beyond the raw materials level. Indeed, the planning activities of the provincial government cover also other types of inputs required for the production of technologically developed products. The level of detail included in the Plan is very high and demonstrates that the Chinese government is intervening heavily into the market on the provincial level. The research into other provinces confirms that there are similar initiatives and documents in other provinces of China; however Hebei was randomly chosen as a demonstration province for the purpose of this chapter.

Guiding concepts and development targets

The Hebei New Material Industry Plan starts with listing the guiding concepts and development targets for development in Hebei province, which show a clear intention of the government to take a leading role in the development of industry. The Plan includes provisions on the development of industry, aiming at shifting from raw materials to new materials:

consider technological innovation as a major tool; consider industrialisation as the main direction; consider key projects as a leverage tool; consider innovation in institutional systems and policy support as means to ensure implementation; fully use the enterprises' leading role; […], focus on raising the industry concentration level; expand and enhance sectors having an advantage including special metal materials, new green materials, electronics and IT materials, modern chemical materials etc; speed up the development of frontier materials such as graphene, super-hard materials, nano-materials, 3D printing materials etc; strive to make new materials a strong driving force to ensure the development

[998] See 13th FYP for Forestry Development, Section III-1
[999] Hebei 2016 New Material Industry Development Promotion Plan
http://www.hbdrc.gov.cn/web/web/xxgkcyfz/4028818b521b189e01522f5a3be9126d.htm
[1000] No explicit reference is made in the provincial plan to the national plan. National level Guide for the Development of the New Materials Industry:
http://www.miit.gov.cn/n1146295/n1146562/n1146650/c5473570/content.html

of the province's new emerging industries; promote Hebei's shift from being an important province for raw materials to becoming an important province for new materials. [1001]

The 2016 targets included in the Plan refer to industry expansion, development of new products, industrial concentration and enhancement of leading enterprises:

- Keep expanding the industry scale: add RMB 30 billion added value on top of the current province's new material industry scale; raise the share of the new material industry in the new emerging industry sector by 1%; […]

- In Hebei's sectors having an advantage: implement a number of technological innovation and major industrialisation projects; strive to ensure a breakthrough in some common key-technologies; optimise a number of technical processes and develop a number of new products.

- Enhance the concentration effect: guide and concentrate new materials enterprises and projects towards major areas; enhance efforts to foster leading enterprises; further enhance the concentration degree of sectors such as electronics and IT materials, new green materials, modern new chemical materials etc.[1002]

Promotion of key technology research and industrialisation demonstration projects

Section III of the Plan refers to the promotion of key technology research and industrialisation demonstration projects. The industries covered by the Plan are divided into five main categories and each category is divided into three sections: list of materials to be developed, major technological research development goals and industrialisation projects to be implemented:

- Special metal materials

The plan envisages to '*strongly develop steel products such as steel used for high-speed railways, steel used for automobiles, steel for shipbuilding, steel used for high-speed tools, steel used for the electricity industry, steel used for high-grade pipes and cables etc; Speed up the development of high-performance, high-strength, highly abrasion-resistant alloy products of zirconium, aluminium, vanadium, titanium, magnesium etc.*'

Furthermore, it sets out the goal to create 5 industry chains:

- High performance alloy steel smelting → high precision processing → alloy steel products;

[1001] See Hebei 2016 New Material Industry Development Promotion Plan, Section II.
[1002] Ibid., Section II.

- Vanadium-titanium magnetite ore smelting → high- quality intermediate alloy →development of vanadium-titanium steel new products → comprehensive use of vanadium and titanium resources;

- High-performance aluminium alloy casting → automobile spare parts and high-precision aluminium profiles;

- Tungsten, cobalt, molybdenum, tantalum, niobium and other raw materials → hard alloy products → hard alloy tools and other super-hard materials,

- Iron, iron-nickel and cobalt amorphous materials → amorphous strip → amorphous transformers.

Major industrialisation projects in the special metal materials category include:

speed up the demonstration and extension of application of advanced technology, such as comprehensive use of resources, molten iron pre-processing, high-speed / constant-speed continuous casting, defect-free slabs, controlled rolling; promote construction of projects with the following capacities:

- *a yearly output of 400 000 tonnes of cold-rolled silicon steel;*
- *a yearly output of 10 000 tonnes of super-tough mould steel used for automobiles etc.;*
- *a yearly output of 100 000 tonnes of super-strong alloys used for automobiles;*
- *a yearly output of 50 000 units of diamond drill bits;*
- *a yearly output of 50 000 tonnes of high-quality manganese alloy;*
- *a yearly output of 300 000 tonnes of high-purity, (extra-high-purity) pig iron;*
- *a yearly output of 1.2 million tonnes of welding new materials;*
- *a yearly output of 10 000 tonnes of vanadium-aluminium alloys and of molybdenum-aluminium alloys.*[1003]

- New green materials

The development goals include:

vigorously develop new wall materials, energy-saving glass, thermal insulation materials, waterproof sealing materials, recycled construction materials and products as well as other new construction materials; speed up R& D on construction material technologies such as lightweight high-strength panels, composite panels and construction coatings etc. […]

As a priority, create 2 industry chains:

[1003] Ibid., Section III-1.

- energy-saving glass coating → energy-saving glass → energy-saving doors and windows products;

- new lightweight and high-strength green construction materials → inside and outside wall insulation panels → green energy-saving building solutions and plans.

The list of major industrialisation projects is as follows:

Promote construction of projects with the following capacities:

- a yearly output of 300 000 m2 of energy saving doors and windows for high-energy-performance buildings,

- a yearly output of 16 million m2 of membrane glass,

- a yearly output of 80 000 tonnes of environmentally friendly water-based paint,

- a yearly output of 6 million m2 of ornamental fire-retardant aluminium composite panels,

- a yearly output of 50 000 tonnes of insulating powder material,

- a yearly output of 10 000 tonnes of basalt continuous fibers and products.[1004]

- Electronics and IT materials

The development goals include:

Consolidate advantages in sectors of single crystal, polycrystalline silicon batteries; actively develop chemical compound batteries and membrane photovoltaic cells; expand R&D as regards energy storage materials and products; strongly develop liquid crystal materials, glass substrates and semi-conductor lighting materials for flat-screen displays; expand the production scale and enhance the quality of organic photo-conductors and toner materials. […]

Create 3 industry chains:

- crystal silicon → silicon film, photovoltaic glass → cells, EVA/ back panel → Photovoltaic modules;

-liquid crystal materials, glass substrates → flat screen display devices;

-solid luminescent materials → photo-electronic devices → LED application products.

[1004] Ibid., Section III-2.

Major industrialisation projects include:

speed up the industrialisation pace of new rare-earth lithium-ion batteries, large-diameter epitaxial wafers, high-purity silicon carbide; foster the construction of projects with:

- the yearly output of 1,000 tonnes of special electronic gas for dust and extra-large integrated circuits,

- the yearly output of 9,570 m2 of transparent oxide resistant membrane,

- the yearly output of 36 million m2 of PE membrane for lithium-ion batteries,

- the yearly output of 12 million m2 of coated modified membrane etc.[1005]

- Modern chemical materials

Development goals:

speed up the development of synthetic rubber, synthetic resine and synthetic fibers; strongly develop polycarbonate, specific types of PVC resin, fluorine resin, automotive polypropylene resin used for automobiles, POM and other polymer material. […]

Create 2 industry chains:

- specific thermoplastic composite materials → thermoplastic composite material products→ thermoplastic composite materials for automotive and engineering machinery applications;

- clear polypropylene → Carbon Fiber polypropylene → Carbon materials → spare parts for aerospace, vehicles, engineering machinery.

Major industrialisation projects include:

- *a yearly output of 12 500 tonnes of carbon fiber composite materials,*
- *a yearly output of 100 000 tonnes of rubber nano-composite materials,*
- *a yearly output of 200 000 tonnes of water-based coatings used for automobiles,*
- *a yearly output of 40 000 tonnes of rubber auxiliary products,*
- *a yearly output of 8 million m2 aramid coated membranes.*[1006]

- Frontier materials (graphene materials, metastable materials, super-hard materials, super-conducting materials, nano-materials, materials used for 3D printing)

[1005] Ibid., Section III-3.
[1006] Ibid., Section III-4.

The Plan envisages to '*strengthen forward-looking innovation and research on new materials; promote a number of key technological research and industrialisation projects'.*

Some specific production goals include:

- For graphene materials: '*strengthen production technology research and application research on high-quality, low-cost graphene; Strengthen construction of projects with a yearly output 100 tonnes of graphene material; expand the application and promotion of graphene in downstream industries.'*
- For metastable materials, super-hard materials and super-conducting materials the plan envisages a number of research and technological development goals.
- For nano-materials: '*develop high-performance nano-catalysts, carbon nano-tubes, carbon nano-fibers, nano-purification nano-materials, nano-metals; Speed up construction of projects with a yearly output of 600 tonnes of nano-zinc oxide'.*
- For materials used for 3D printing: '*actively explore preparations and technologies allowing for the industrialisation of low-cost alloy powder material used for 3D printing'.*[1007]

Establishment of key industry bases in Hebei

Section IV of the Plan concentrates on the promotion of the establishment of key industry bases in Hebei. The plan includes specific provisions on qualitative and quantitative production goals, the levels of investment, geographical distribution of different industries, production and capacity expansion etc. To demonstrate the level of detail and state intervention, the provisions of Section IV are presented below in their entirety:

> *- Shijiazhuang national base for the industrialisation of high-technologies in the field of semi-conductors and lighting high-technology: start implementing the strategic cooperation agreement concluded between the China Electronics Technology Group Corporation (CETC) and the Hebei Province; speed up projects under construction; speed up the industrialisation pace of products such as LED semi-conductor materials, new types of semiconductive chemical compound materials, large-diameter epitaxial wafers, liquid crystal materials, extra-thin substrate glass and complete sets of equipment; speed up the formation of relatively competitive sectoral clusters in the field of semi-conductors and lighting.*
>
> *- Tangshan national base for the industrialisation of high-technologies in the field of steel materials and Torch Programme industry base for ceramic materials: further expand R&D investments; expand the scale of production; accelerate development of steel for high-speed tools, powder metallurgy, high-speed steel, die steel, titanium sponge and other advanced steel materials as well as ceramic materials such as industrial chemical ceramics, high-temperature high-aluminium*

[1007] Ibid., Section III-5.

ceramics, and special ceramics, etc.; strive to reach a growth in sales income of more than 10% and to ensure that in major enterprises the ratio of R&D investments/sales income reaches 2%.

- Handan national Torch Programme industry base for new materials: speed up the development of products such as office automation consumables, gases for electronics, metal resources, high-performance carbon fibers, aramid fibers, basalt fibers and related applications; promote the expansion of key competitive products, move up the [value] chain; by the end of 2016, the production capacity for organic photo-conductors shall reach 35 million units, toner black powder 10 000 tonnes, color powder 2 000 tonnes, gas for electronics industry 2 000 tonnes, high-purity aluminium oxide 10 000 tonnes.

- Chengde national base for the industrialisation of high-technologies in the field of vanadium and titanium materials: Speed up research and product development related to vanadium and titanium magnetite smelting technology; raise the level of comprehensive use technologies applicable to vanadium and titanium resources; actively develop vanadium oxide, micro-vanadium alloys, titanium processed materials and titanium ultra-fine powder and other products; strive to raise production scale and production capacities steadily; consolidate the position of the largest vanadium and titanium industrialisation base in Northern China.

- Xingtai national base for the industrialisation of photovoltaic high-technologies: consider Ningjin county as an industry base for solar silicon materials; speed up the development and expansion of crystalline silicon cells and components, thin membrane solar cells, light & heat use, energy storage technologies and other products; ensure an annual investment of RMB 7 billion, attract 10 new enterprises and achieve RMB 49 billion of sales income.

- Hengshui national Torch Programme's special industry base for construction rubber: further expand quantity and ensure quality; speed up the development of laminated rubber bearings, pot rubber bearings, spherical bearings, rubber water seals, bridge expansion devices and other products; over the whole year, strive to start more than 30 programmes of more than RMB 100 million, introduce 5 Beijing-Tianjin cooperation projects, and ensure that sales of these products have a market share on the domestic market of more than 50%.

In parallel, relying on the local industrial bases and support conditions, speed up the promotion of specialised bases such as:

- modern functional glass and art glass in Shahe,

- the international innovation park for construction energy-saving technologies, in Gaobeidian,

- chemicals used in the automobile industry in Cangzhou

- environmentally friendly water-based paint in Xushui,

- thermal insulation builing materials in Dacheng,

- aluminium panels in Guangping, etc; […]

- strive to establish a new arrangement to develop a new material sector with distinctive characteristics, and ensure harmonious development, (industry) chain improvements, functional improvements etc. […].[1008]

The implementation of the Plan is ensured through a number of instruments, including the following financial measures:

Strengthen financial support. […] use the provincial special fund for the strategic and emerging industries, the industry transformation and upgrade fund, the science and technology special fund and all sorts of funds; strengthen all links of the [industry] chain; -ensure strong support of R&D on key technologies, innovation platform establishment, industrialisation of major innovation achievements, and popularization and application of new technology and new products; speed up the pace of technological innovation and industrialisation of the Province's new material sector.

Expand funding channels. Establish connection mechanisms and regular communication between major new materials enterprises and financial institutions; guide commercial and policy loan funds so that they expand their operations in the field of major new materials and expand their credit support to companies; as regards eligible new material enterprises, support them to be listed on the New OTC Market or GEM for financing, support them to issue corporate bonds and enterprise bonds; set up new material industry venture capital funds in key industrial bases.[1009]

12.3.2.1. COMMENTS – EXAMPLES OF SPECIFIC FINANCIAL SUPPORT MEASURES

As indicated in Chapter 4.2.10, the government of Hebei issued three detailed lists of '*key projects*' for which considerable funds have been allocated for one year.

In the course of the research done for this report it was not possible to find the exact definition of the notion of '*key projects*' and to establish the exact nature of the investments envisaged by the Hebei provincial government. However, the fact remains that a number of new material producing enterprises are included in the 2016 'key project' list of Hebei province.

The first list of key projects covers the '*projects aiming at planning and start of operations*', consisting of a list of 120 enterprises. The list includes the following new materials producers

[1008] Ibid., Section IV.
[1009] Ibid., Section V.

(the list is not exhaustive, as it cannot be excluded that other enterprises on the list are also engaged to some extent in the production of new materials):

3. New materials (11)
- Chengde Taihang New Material Technology Co., Ltd.: Basalt fiber and products (Kuancheng);
- Hebei Maipurun Optics and logistics LTd, : Optical crystals (Qinghe);
- Zhuoli Tinplate New Material (Handan) Co., Ltd.: Metal ultra-thin coated sheet material (Chengan);
- Hebei Shuangcheng Liquid Metal Industry Park Co., Ltd.: Liquid Metal Technology R & D and Application Production (Zaoqiang);
- Hebei Yitai special cable Co., Ltd.: Aluminium alloy special cable and halogen-free, low smoke, flame retardant wire (Guangping);
- Langfang City, Chaofei Electronic Technology Co., Ltd. Organic ceramic-based CCL (Anci);
- Tangshan Jinhengtong Car Material Co., Ltd.: carbon fiber for sports equipment (Lutai)
- Hebei Bo Xiang Special Graphite Co., Ltd. High-performance special graphite (Huanghua);
- Hebei Xinpeng Chemical Co., Ltd. : refined chemicals, oil refining additives (Hejian);
- Hebei Rollas Power Technology Co., Ltd.: production lines for preformed helical fitting - and special cable (Renqiu);
- Hebei Daze Technology Development Co., Ltd. new materials for special protection (Jize).[1010]

The second batch of '*key projects*' issued by the Hebei NDRC covers '*Projects aiming at continuing construction and getting fully operational*' and consists in total of 100 names of enterprises, including the following new materials producers:

3. New materials (4)
- Kangde Composites Co., Ltd: Carbon Fiber Composites (Anci);
- China Lucky Group Co., Ltd. : Lucky new material industry park (Mancheng);
- Handan City Fengfeng Xinbao New Material Technology Co., Ltd. New Materials (Fengfeng Mining Area);
- Cangzhou Great drills Co., Ltd: Oil Drills (Hejian).[1011]

The total funds attributed to the 120 enterprises from the '*Projects aiming at planning and start of operations*' list and the 100 enterprises listed in the '*Projects aiming at continuing*

[1010] The full list is available at: http://www.hbdrc.gov.cn/web/web/zdb_ndjh/4028818b547a2b60015484a55efa3606.htm (last accessed on 15 November 2017)
[1011] The full list is available at: http://www.hbdrc.gov.cn/web/web/zdb_ndjh/4028818b5496109a01549dd2e60a509b.htm (last accessed on 15 November 2017)

construction and getting fully operational' category amount to RMB 236.33 billion in 2016 and RMB 1 070.64 billion in total.[1012]

The third batch of Hebei's '*key projects'* includes 120 enterprises under the '*pre-projects'* category. The new material enterprises included in the list are:

3. New materials (9)

- China Triumph Technology Group: Copper indium gallium selenium (CIGS) for thin film solar modules (Qinhuangdao Economic Development Zone);
- China Iron & Steel Research Institute Group: industrialisation of LED-grade sapphire crystal bars (Handan Economic Development Zone);
- China-Korea joint investment Tianda Chemical Co., Ltd.: Polyimide film monomer materials for flexible liquid crystal display (Hengshui Industrial New Area);
- Hebei Outong Nonferrous Metal Products Co., Ltd. and Chinalco Aluminium Luoyang Copper Co., Ltd.: High-performance chromium zirconium and copper (Wuqiang);
- Hebei Zhongxing Carbon Fiber Chemical Co., Ltd: High-performance carbon fiber production (Jingxian);
- Hebei Fujing special glass new materials Technology Co., Ltd.: High-borosilicatenew materials (Xingtai Development Zone);
- Bolin Hightech (Beijing) Petroleum Chemical Co., Ltd.: Metal structures used to produce of oil products (Julu);
- Zhongxinfang Hebei Residential Industry Co., Ltd. Industrialisation of new housing models (PC Components) (Yuanshi);
- Hebei Xuelong Machinery Manufacturing Co. Ltd.: industrialisation of housings (Xinji).[1013]

The funds attributed to the 120 enterprises in the third list amount to RMB 1 110.65 billion in total.[1014]

It has to be noted that Made in China 2025 sets out strict self-sufficiency targets: by 2020, 40% of essential spare parts and key materials should have domestic sources and by 2025 the share of domestically sourced materials should reach 70%. The plan described above and its implementation is clearly one of the means to achieve this goal.

[1012] Source: Hebei DRC, 29 August 2016 http://www.hbdrc.gov.cn/web/web/xwbd/4028818b56610e0c0156d3ade8022bb5.htm (accessed on 10 October 2017).
[1013] The full list: http://www.hbdrc.gov.cn/web/web/zdb_ndjh/4028818b5496109a01549dd4e40d5194.htm (accessed on 10 October 2017).
[1014] Source: Hebei DRC, 29 August 2016 http://www.hbdrc.gov.cn/web/web/xwbd/4028818b56610e0c0156d3ade8022bb5.htm (accessed on 10 October 2017).

12.4. MEASURES IMPACTING THE EXPORT OF RAW MATERIALS

12.4.1. INTRODUCTORY REMARKS

The economic situation of companies will also depend on the conditions of the supply of raw materials. Government measures which favour the domestic consumption of raw materials as opposed to an allocation of raw materials on the basis of international supply and demand, tilt the level playing field in favour of the domestic downstream industry. Put differently, these restrictions influence export activities by increasing the relative price of exported products, decreasing the quantity supplied or changing the terms of competition among suppliers. The OECD Inventory of Export Restrictions on Industrial Raw Materials lists the following types of export restrictions:

- export tax;
- fiscal tax on exports;
- export surtax;
- export quota;
- export prohibition;
- licensing requirement;
- minimum export price;
- VAT tax refund reduction or withdrawal;
- restriction on customs clearance point for exporters;
- qualified exporters list;
- domestic market obligation;
- captive mining;
- other export measures.[1015]

Those, as well as any other types of measures restraining exports, such as dual pricing schemes (included in the 2015 but not in the 2016 OECD methodological note) drive domestic prices down and create a comparative advantage for the domestic producers. An OECD study on the subject recognises that export restrictions *'indirectly subsidise domestic industries that use the restricted commodity as input. Assisting downstream industries to grow and compete may be the intended result of such restrictions'*.[1016]

Export restrictions can lead to considerable price differences between China and the world market. The export restrictions in practice limit the exports significantly (depending on the amount of the export duty) and keep the products on the domestic market. The increased supply on the domestic market, which is not necessarily linked with an increased demand, drives the domestic prices for those products down. This means that the downstream industry gains access to cheaper raw materials. The cheaper raw materials mean lower cost of

[1015] OECD. (2016). *Methodological note to the Inventory of Export Restrictions on Industrial Raw Materials*, OECD, 09 March 2016, http://www.oecd.org/tad/benefitlib/inventory-export-restrictions-ind.pdf (accessed on 10 October 2017).
[1016] OECD. (2014). *Export Restrictions in Raw Materials Trade: Facts, Fallacies and Better Practices.* OECD Publishing

production and enable the downstream industry of the country imposing the export restrictions to undercut the international prices of the downstream products and expand their exports of the finished products. All this is at the cost of a distorted market for raw materials.

According to the OECD Inventory on export restriction on industrial raw materials, China is currently applying export duties, export quotas, non-automatic export licensing requirements as export restricting measures on some goods. Certainly this list is not exhaustive. For example, China also applies VAT tax refund reductions or withdrawals. Chinese producers can often purchase raw materials cheaper than foreign competitors. This provides them with a strong competitive advantage with regard to both prices and availability.[1017]

12.4.2. EU-WTO DISPUTES WITH CHINA ON EXPORT RESTRICTIONS

If one or very few countries command a large share of global output of certain critical or otherwise important raw materials, foreign customers have very few alternative sources to turn to. As an example, China is a world leader in the production of the following raw materials which are subject to export restrictions: rare earths (91% of the global output), magnesite (65%), fluorspar (62%), vanadium (53%), phosphates (44%), molybdenum (42%). [1018] The export restrictions in place have had serious repercussions for global commodity prices. For example between 2010 and 2011 the prices of antimony, tungsten and rare earths as a whole doubled, whereas some elements like lanthanum and cerium (both rare earths) increased by 900%.[1019] In most cases there were few or no substitutes available for many of the necessary inputs, and substitution would incur significant increase in the production costs or compromise the performance of the product in which the input is used.[1020]

To date, the EU already brought three WTO disputes against export restricting measures imposed on raw materials by the Chinese government.

Following the legal action by the EU, China abolished the export restrictions on the raw materials subject to those disputes. However, China continues to impose export restrictions on a number of other raw materials and other products. This fact has been a long standing concern for the EU and other WTO Members.

12.4.2.1. - WT/DS395 - CHINA — MEASURES RELATED TO THE EXPORTATION OF VARIOUS RAW MATERIALS

On 23 June 2009, together with the US and Mexico, the EC requested consultations with China regarding various export restrictions on the exportation of certain raw materials from

[1017] For example due to an export tax and no VAT refund for raw materials for seamless stainless steel pipes and tubes, the prices of these raw materials in China were around 30% lower than in USA and EU. See Commission Regulation (EU) No 627/2011 of 27 June 2011 imposing a provisional anti-dumping duty on imports of certain seamless pipes and tubes of stainless steel originating in the People's Republic of China, recitals 26 and 27.
[1018] OECD. (2014). *Export Restrictions in Raw Materials Trade: Facts, Fallacies and Better Practices.* OECD Publishing
[1019] Ibid.
[1020] Ibid.

China. The case covered various forms of bauxite, coke, fluorspar, magnesium, manganese, silicon carbide, silicon metal, yellow phosphorus and zinc. The export restrictions were mainly quotas (bauxite, coke, fluorspar, silicon carbide and zinc), export duties (bauxite, coke, fluorspar, magnesium, manganese, silicon metal, yellow phosphorus and zinc), a minimum export price system, as well as additional requirements and procedures that exporters had to meet. The Panel and the Appellate Body found China in violation of various WTO provisions.[1021] China complied with the ruling and removed the measures found to be in violation of its WTO obligations (with no retroactive effect).

12.4.2.2. - WT/DS432 - China - Measures Related to the Exportation of Rare Earths, Tungsten and Molybdenum

On 13 March 2012, the EU, together with the US and Japan, requested consultations with China on China's export restrictions regarding 17 forms of rare earths, as well as tungsten, and molybdenum. The export restrictions were mainly export duties and quotas as well as additional requirements and procedures linked to the quota administration. Both the Panel and the Appellate Body confirmed in 2014 that China's export restrictions on rare earths, as well as on tungsten and molybdenum, were in breach of WTO rules.[1022] China complied with the ruling and removed the measures found to be in violation of its WTO obligations (with no retroactive effect).

12.4.2.3. - WT/DS509 - China — Duties and other Measures concerning the Exportation of Certain Raw Materials

In October 2014, the EU and the US, requested the establishment of a WTO dispute settlement panel to examine China's export quotas and/or export duties on 12 raw materials – antimony, chromium, cobalt, copper, ferronickel, graphite, indium, lead, magnesia, talc, tantalum, and tin. The raw materials in question are key inputs into a wide range of high-value products in vital industrial sectors, including steel, automotive, aerospace, construction, and electronics. The WTO dispute settlement on this matter is currently ongoing.[1023]

China removed the export restrictions which were challenged through this dispute, but no formal settlement has been reached between the Parties on this matter.[1024]

[1021] Appellate Body Report, AB-2011-5, China – measures related to the exportation of various raw materials, 30.01.2012, https://www.wto.org/english/tratop_e/dispu_e/394_395_398abr_e.pdf
[1022] Appellate Body Report, AB-2014-3, AB-2014-5, AB-2014-6, China – measures related to the exportation of rare earths, tungsten, and molybdenum
[1023] See European Commission, DG Trade website. *EU files WTO panel request against Chinese export restrictions on raw materials*, 26.10.2016, http://trade.ec.europa.eu/doclib/press/index.cfm?id=1566
[1024] Ibid.

12.4.3. EXPORT RESTRICTIONS APPLIED BY CHINA

12.4.3.1. EXPORT DUTIES

An export duty, also referred to as an export tax, export tariff, export levy or export charge, is a tax collected on goods or commodities when they leave a customs territory. It can be set either on a *per unit* or an *ad valorem* basis.[1025]

The imposition of export duties is not per se WTO-inconsistent for most WTO Members. However, the imposition of export duties in practice limits the exports significantly (depending on the amount of the export duty) and keeps the products on the domestic market. As already noted above, the increased supply on the domestic market, which is not necessarily linked to an increased demand, is likely to drive the domestic prices for those products down. This in turn can imply that the downstream industry gains access to cheaper raw materials, with accordingly lower costs of production. Depending on the circumstances of the case, this can have as a consequence to enable the downstream industry of the country imposing the export duties to undercut the international prices of the downstream products and expand their exports of the finished products.

China is one of the few WTO Members who undertook as a part of its accession obligations to eliminate export duties, unless otherwise specified in the Protocol. Paragraph 11.3 of China's Accession Protocol states that '*China shall eliminate all taxes and charges applied to exports unless specifically provided for in Annex 6 of this Protocol or applied in conformity with the provisions of Article VIII of the GATT 1994'.* Annex 6 is entitled '*Products Subject to Export Duty'*. It contains a table listing the 84 different products (each identified by an eight-digit Harmonized System (HS) number and product description), and specifies a maximum export duty rate for each.

China maintains basic framework legislation authorising the imposition of export duties:

- *Foreign Trade Law of the People's Republic of China* (as revised on 17 November 2016);
- *Customs Law of the People's Republic of China* (adopted at the 19th Meeting of the Standing Committee of the Sixth National People's Congress on 22 January 1987, amended 28 December 2013, in Order No 8, and then revised on 4 November 2017);
- *Regulations of the People's Republic of China on Import and Export Duties* (State Council, Order No. 392, adopted at the 26th executive meeting of the State Council on 29 October 2003, amended 1 March 2017, in Order No. 676);
- *State Council Customs Tariff Commission Notice on Issuing the 2017 Tariff Adjustment Plan* (State Council Customs Tariff Commission, Shui Wei Hui [2016] No. 31, issued 19 December 2016, effective 1 January 2017) (the '2017 Tariff Adjustment Plan');

[1025] OECD, *Export Restrictions in Raw Materials Trade: Facts, Fallacies and Better Practices* (OECD Publishing, 2014).

- *General Administration of Customs Notice on the 2017 Tariff Adjustment Plan* (General Administration of Customs, Zong Shu Gong Gao [2016] No. 89, issued 30 December 2016, effective 1 January 2017).

The *2017 Tariff Adjustment Plan* sets out specific export duty rates applicable to certain products during a given year.

In 2012, China imposed export duties on 363 products. After WTO litigation in 2012 a number of products were removed from the list. In 2017 China imposed export duties on 213 products.

The table below includes the full list of products subject to export duties.

Table 14: List of products subject to export duties in 2017

- Acid-Processed Bone Collagen and Bone
- Alloy Steel Ingots and Alloy Steel in Other Primary Forms
- Alloyed Pig Iron
- Aluminum Alloy Bars and Rods with Cross-Sectional Circumference Greater Than or Equal to 210mm
- Aluminum Alloy Bars and Rods with Cross-Sectional Circumference Less Than 210mm
- Aluminum Alloy Hollow Profiles
- Aluminum Alloy Wire with Maximum Cross-Sectional Dimensions Exceeding 7mm
- Aluminum Waste Materials
- Aluminum-Rich Andaulsite
- Andalusite, Kyanite, and Sillimanite, Calcined and Uncalcined
- Antimony Powder
- Antimony Waste Materials
- Bamboo Pulp
- Benzene
- Bleached Coniferous Alkali Wood Pulp or Sulfate Wood Pulp
- Bleached Coniferous Sulfite Wood Pulp
- Bleached Non-Coniferous Alkali Wood Pulp or Sulfate Wood Pulp
- Bleached Non-Coniferous Sulfite Wood Pulp
- Bone Meal and Bone Waste Containing Cattle and Sheep Ingredients
- Carnallite, Potash, and Other Natural Crude Potassium Salts
- Cast Iron Waste Material
- Chemical Wood Pulp, Dissolving Grade
- Chrome-Zirconium-Copper Bars, Rods, Extrusions and Profiles
- Coal Briquettes, Coal Balls, and Similar Solid Fuel Formed of Coal
- Coiled Copper-Zinc Alloy Plates, Sheets and Strips
- Coiled Refined Copper Plates, Sheets and Strips with Oxygen Content Not Exceeding 10 PPM
- Coiled Tin-Copper Alloy Plates, Sheets, and Strips
- Coniferous Wood Chips or Wood Particles
- Coniferous Wood Floorboards (Blocks)
- Copper Master Alloys
- Copper Waste Materials
- Copper-Nickel Alloy or Copper-Nickel-Zinc Alloy Plates, Sheets and Strips
- Copper-Nickel-Zinc-Lead Alloy (Leaded German Silver) Wire
- Copper-Zinc Alloy Bars and Rods with Straightness of Less Than 0.5mm/m

- Copper-Zinc Alloy Wire
- Crude Antimony (Antimony Concentrate, Ore Dressing Products)
- Crude Benzene
- Crude Cast Forging Stock with Unit Weight ≥ 10 Tonnes
- Deglued Bones and Horn Cores
- Eel Fry
- Ferrochrome, Carbon Content > 4%
- Ferrochrome, Carbon Content ≤ 4%
- Ferromanganese, Carbon Content > 2%
- Ferromanganese, Carbon Content ≤ 2%
- Ferroniobium
- Ferro-Silico-Chrome
- Ferro-Silico-Manganese
- Ferrosilicon, Silicon Content > 55%
- Ferrosilicon, Silicon Content ≤ 55%
- Ferrotitanium and Ferro-Silico- Titanium
- Fertilisers Containing the Two Elements of Phosphorus and Potassium
- Fiber Pulp Extracted from Recycled Paper or Cardboard
- Finished Lignite
- Fragmented Steel Iron Ingots Provided for Resmelting
- Grey Feed-Grade Zinc Oxide (Zinc Oxide ZnO Content of Greater than 80%)
- Ground Apatite
- Ground Natural Calcium Phosphate, Natural Aluminum Calcium Phosphate and Phosphalic Chalk, Excluding Apatite
- High-Purity Copper Cathodes (Copper Content Greater Than 99.9935%, but Less Than 99.9999%)
- High-Purity Copper Cathodes (Copper Content Not Less Than 99.9999%)
- High-Purity Nickel (Nickel Content Greater Than 99.99%, Cobalt Content No Greater Than 0.005%)
- High-Purity Pig Iron (manganese content <0.08%, phosphorus content <0.03%, sulfur content <0.02%, titanium content <0.03%)
- Hot-Rolled Wire Rods with Rolling Pattern
- Hot-Worked Bars and Rods with Rolling Pattern
- Hot-Worked Easy-Cut Steel Bars and Rods
- Hydrated Tantalum-Niobium Materials (Enriched Tantalum- Niobium)
- Iron and Unalloyed Steel in Other Primary Forms
- Iron and Unalloyed Steel Ingots
- Iron Products Directly Reduced from Iron Ore
- Lead Ore Sand and its Concentrate
- Lignite
- Low-Alkali Refined Aluminum Alloy with Alkali Metal Content (Na + K + Ca) < 10ppm and Hydrogen Content < 0.12ml/100gAl
- Manganese Residue Produced in Steel Iron Smelting
- Mechanical Wood Pulp
- Mercury Sulfide (Cinnabar)
- Natural Barium Carbonate (Witherit), Calcined and Uncalcined
- Nickel Anodes for Use in Electroplating
- Nickel Ore Sand and its Concentrate
- Nickel Waste Materials
- Nitrogen-Phosphorus- Potassium Compound Fertiliser
- Non-Coniferous Wood Chips or Wood Particles
- Non-Rectangular Aluminum Alloy Plates, Sheets and Strips

- Non-Rectangular Plates, Sheets and Strips Made of Unalloyed Aluminum
- Ore Dust and Residue Containing Antimony, Beryllium, Cadmium, Chromium and Mixtures Thereof
- Ore Dust and Residue Containing Arsenic, Mercury, Thallium and Mixtures Thereof, Used in the Extraction or Production of Arsenic, Mercury, Thallium and Compounds Thereof
- Ore Dust and Residue Containing Other Metals and Chemical Compounds
- Ore Dust and Residue Primarily Containing Copper
- Other Alloy Steel Billets, excluding alloy steel billet with diameter ≥700mm
- Other Alloy Steel Waste Material
- Other Aluminum Alloy Wire
- Other Bone Meal and Bone Waste
- Other Bones and Horn Cores (Excluding Deglued Bones and Horn Cores)
- Other Coiled Refined Copper Plates, Sheets and Strips
- Other Cold-Worked Easy-Cut Steel Bars and Rods
- Other Cold-Worked or Cold- Shaped Bars and Rods
- Other Copper Alloy Bars, Rods, Extrusions and Profiles
- Other Copper Alloy Plates, Sheets and Strips
- Other Copper Alloy Wire
- Other Copper-Zinc Alloy Bars and Rods
- Other Copper-Zinc Alloy Extrusions and Profiles
- Other Copper-Zinc Alloy Plates, Sheets and Strips
- Other Easy-Cut Steel Hot- Rolled Wire Rods
- Other Extrusions and Profiles Manufactured from Aluminum Alloy
- Other Ferro Vanadium
- Other Fibrous Cellulosic Chemical Pulp
- Other Fibrous Cellulosic Mechanical Pulp
- Other Fibrous Cellulosic Semi- Chemical Pulp
- Other Granular Slag (Slag Sand) Produced in Steel Iron Smelting
- Other Hot-Rolled Wire Rods
- Other Hot-Worked Bars and Rods
- Other Hot-Worked Rectangular Cross-Sectioned Bars and Rods
- Other Iron and Sponge Iron, Product Purity > 99.94%
- Other Iron and Unalloyed Steel Bars and Rods
- Other Mineral Potassium Fertilisers and Chemical Potassium Fertilisers
- Other Non-Coniferous Wood Floorboards
- Other Ore Dust and Residue Primarily Containing Lead
- Other Ore Sand and its Concentrate
- Other Phosphorus
- Other Potassium Chlorides
- Other Precious Metal Ore Sand and its Concentrate
- Other Rectangular Aluminum Plates, Sheets and Strips Made of Unalloyed Aluminum with Thickness 0.3mm or Greater But Not Exceeding 0.36mm
- Other Rectangular Cross- Sectioned Steel Billets, C, 0.25%
- Other Rectangular Plates, Sheets and Strips Made of Unalloyed Aluminum
- Other Rectangular Plates, Sheets and Strips of Unalloyed Aluminum and Plastic Composite
- Other Refined Copper Bars, Rods, Extrusions and Profiles
- Other Refined Copper Cathode Extrusions
- Other Refined Copper Cathodes
- Other Refined Copper Plates, Sheets and Strips
- Other Refined Copper Wire
- Other Round Cross-Sectioned Hot-Rolled Wire Rods with Diameter < 14mm

- Other Stainless Steel Semi- Finished Products
- Other Steel Billets With Carbon Content < 0.25%
- Other Steel Iron Waste Materials
- Other Tantalum-Niobium Ore Sand and its Concentrate
- Other Tin-Copper Alloy Plates, Sheets, and Strips
- Other Unalloyed Aluminum Wire
- Other Unfinished Bituminous Coal, Powdered and Unpowdered
- Other Unfinished Coal, Powdered and Unpowdered
- Other Unwrought Aluminum Alloys
- Other Unwrought Copper Alloys
- Other Unwrought Refined Copper
- Other White Copper or German Silver Wire
- Peat (Including Peat for Use as Fertiliser), Finished and Unfinished
- Petroleum Crude and Crude Oil Extracted from Uraninite
- Pickled Chromium Manganese Stainless Steel Coils with Thickness of Less Than 3 mm and 5.5% or More Manganese Content By Weight
- Pickled Chromium Manganese Stainless Steel Coils with Thickness of More Than 3 mm but Less Than 4.75 mm and 5.5% or More Manganese Content By Weight
- Potassium Heptafluorotantalate
- Potassium Nitrate for Use in Fertilisers
- Potassium Sulfate
- Product Name (Abbreviation)
- Product Name (Abbreviation)
- Product Name (Abbreviation)
- Product Name (Abbreviation)
- Product Name (Abbreviation)
- Raw Goat Skins Subjected to Reverse-Tanning Process
- Raw Goat Skins, Excluding Those Subjected to Reverse- Tanning Process
- Rectangular Aluminum Plates, Sheets and Strips Made of Aluminum Alloy with Thickness > 4mm
- Rectangular Aluminum Plates, Sheets and Strips Made of Aluminum Alloy with Thickness 0.28mm or Greater But Not Exceeding 0.35mm
- Rectangular Aluminum Plates, Sheets and Strips Made of Aluminum Alloy with Thickness Greater Than 0.35mm But Not Exceeding 4mm
- Rectangular Aluminum Plates, Sheets and Strips Made of Aluminum Alloy with Thickness Less Than 0.28mm
- Rectangular Aluminum Plates, Sheets and Strips of Aluminum Alloy and Plastic Composite with Thickness Greater Than 0.35mm But Not Exceeding 4mm
- Rectangular Aluminum Plates, Sheets and Strips of Unalloyed Aluminum and Plastic Composite with Thickness 0.3mm or Greater But Not Exceeding 0.36mm
- Rectangular Cross-Sectioned Stainless Steel Semi-Finished Products
- Rectangular Cross-Sectioned Steel Billets with Width < 2X Thickness, C < 0.25%
- Refined Copper Billets
- Refined Copper Wire Bars
- Refined Copper Wire with Maximum Cross-Sectional Size > 6mm
- Roasted Pyrite
- Semi-Chemical Wood Pulp
- Silver Ore Sand and its Concentrate
- Sintered Iron Ore Sand and its Concentrate
- Slag, Dross, Oxide Scale and Other Waste Produced in Steel Iron Smelting
- Sludge Containing Leaded Gasoline and Sludge Containing Leaded Antiknock Compounds

- Stainless Steel Ingots and Other Products in Primary Forms
- Stainless Steel Waste Material
- Steel Billets with Carbon Content ≥ 0.25%
- Tar and Mineral Tar Derived from Coal, Lignite or Peat Distillation, Dehydrated or Partially Distilled, Including Reconstituted Tar (Excluding "Carbon Black Oil" Containing Anthracene Oil ≥ 50% and Pitch ≥ 40%)
- Tin Ore Sand and its Concentrate
- Tin-Plated Steel Iron Waste Material
- Titanium Ore Sand and its Concentrate
- Tungsten Ore Sand and its Concentrate
- Unalloyed Aluminum Bars and Rods
- Unalloyed Aluminum Extrusions and Profiles
- Unalloyed Aluminum wire with Maximum Cross-Sectional Dimensions Exceeding 7mm
- Unalloyed Aluminum with Aluminum Content of 99.95% or More by Weight
- Unalloyed Aluminum with Aluminum Content of Less Than 99.95% by Weight
- Unalloyed Pig Iron, Phosphorus Content Greater than 0.5%
- Unalloyed Pig Iron, Phosphorus Content Less Than or Equal to 0.5% (excluding high-purity pig iron with manganese content < 0.08%, phosphorus content <0.03%, sulfur content <0.02%, titanium content< 0.03%)
- Unbleached Coniferous Alkali Wood Pulp or Sulfate Wood Pulp
- Unbleached Coniferous Sulfite Wood Pulp
- Unbleached Non-Coniferous Alkali Wood Pulp or Sulfate Wood Pulp
- Unbleached Non-Coniferous Sulfite Wood Pulp
- Uncalcined Iron Ore Sand and its Concentrate with Average Grain Diameter of Less than 0.8 mm; Excluding Roasted Pyrite
- Uncalcined Iron Ore Sand and its Concentrate with Average Grain Diameter of Not Less than 0.8 mm But Not Greater than 6.3 mm; Excluding Roasted Pyrite
- Unexpanded Chlorites
- Unfinished Anthracite, Powdered and Unpowdered
- Unfinished Coking Coal, Powdered and Unpowdered
- Unground Apatite
- Unground Natural Calcium Phosphate, Natural Aluminum Calcium Phosphate and Phosphatic Chalk, Exluding Apatite
- Unpickled Chromium Manganese Stainless Steel Coils with Thickness of Less Than 3 mm and 5.5% or More Manganese Content By Weight
- Unpickled Chromium Manganese Stainless Steel Coils with Thickness of More Than 3 mm but Less Than 4.75 mm and 5.5% or More Manganese Content By Weight
- Unrefined Copper, Copper Anodes Used in Electrorefining
- Unsintered Iron Ore Sand and its Concentrate with Average Grain Diameter Greater than 6.3 mm, Excluding Roasted Pyrite
- Unwrought Antimony
- Unwrought Copper-Zinc Alloy (Brass)
- Unwrought Nickel Alloy
- Unwrought Tin-Copper Alloy (Bronze)
- Unwrought Unalloyed Nickel
- Unwrought Zinc Alloys
- Unwrought Zinc With 99.99 ≤ Zinc Content < 99.995%
- Unwrought Zinc With Zinc Content < 99.99%
- Unwrought Zinc with Zinc Content of 99.995% or More by Weight
- Uranium Ore Sand and its Concentrate

- Waste Produced in Machine Processing
- Wooden Disposable Chopsticks
- Wooden Toothpicks, Dowels, Popsicle Sticks, Tongue Depressors and Similar Disposable Manufactured Products
- Yellow Phosphorus (White Phosphorus)
- Zinc Ore Sand and its Concentrate (Excluding Grey Feed-Grade Zinc Oxide with Zinc Oxide Content of Greater than 80%)
- Zirconium Ore Sand and its Concentrate

Source: State Council Customs Tariff Commission Notice on Issuing the 2017 Tariff Adjustment Plan (State Council Customs Tariff Commission, Shui Wei Hui [2016] No. 31, issued 19 December 2016, effective 1 January 2017).

Between 2016 and 2017, the number of items on the list was reduced from 250 to 213, and the tariff rate was reduced on another 27 items. Nevertheless, a relatively long list of items are still subject to export duties, the markets for these products and their downstream products are likely distorted as a result.

12.4.3.2. EXPORT QUOTAS

Export quotas are prescribed maximum volumes of exports.[1026]

The GATT drafters considered the imposition of export quotas trade distortive and therefore regulated it. The imposition of export quotas is in principle prohibited under Article XI of the GATT. The effect of export quotas is similar to the effect of export duties (increased supply leads to lower prices on the domestic market, see section 12.4.3.1.).

According to the OECD export restrictions inventory, 40 different product groups were subject to export quotas in China in 2014 (the most recent data published by OECD), including: natural calcium phosphates and natural aluminium calcium phosphates; natural and phosphatic chalk (underground and ground); natural magnesium carbonate 'magnesite'; natural steatite and talc, crushed or powdered; tin ores and concentrates; molybdenum ores and concentrates; rare-earth metals scandium and yttrium, whether or not intermixed or interalloyed; antimony oxides; molybdates; silver, etc.[1027]

The instruments listed below (among others) provide for the imposition of quotas:

- Foreign Trade Law of the People's Republic of China;*[1028]*
- Regulation of the People's Republic of China on the Administration of the Import and Export of Goods;*[1029]*

[1026] Ibid.
[1027] See OECD Inventory on export restrictions on Industrial Raw Materials: http://qdd.oecd.org/subject.aspx?Subject=ExportRestrictions_IndustrialRawMaterials (accessed on 10 October 2017).
[1028] Amended at the 8th Session of the Standing Committee of the Tenth National People's Congress on 6 April 2004 and revised on 17 November 2016.

- Measures for the Administration of Export Commodities Quotas;[1030]
- Measures for Quota Bidding for Export Commodities;[1031]
- Ministry of Foreign Trade and Economic Cooperation Notice on Printing and Distributing the 'Implementation Rules of Export Quota Bidding for Industrial Products';[1032]
- Ministry of Commerce and General Administration of Customs 2016 Public Notice No. 86 on Announcing the '2017 Export Licensing Management Commodities Catalogue';[1033]
- Ministry of Commerce 2016 Public Notice No. 91 on Announcing the '2017 Graded License-Issuing Catalogue of Commodities Subject to Export License Administration';[1034]
- Ministry of Commerce 2017 Public Notice N°68 on Announcing the '2018 Industry Products and Agricultural Products Export Quotas';[1035]
- A large number of annual and semi-annual product specific acts.

Under China's Foreign Trade Law, MOFCOM is responsible for the centralised administration of all export quotas for China. MOFCOM, in collaboration with Customs, is responsible for '*formulating, adjusting, and publishing'* the catalogue listing all goods subject to export quotas. MOFCOM also determines and announces the total amount of the annual export quota for each product covered by the relevant measure by 31 October of the previous year.

China allocates quotas either directly or through a quota bidding system. A decision on allocation must be issued within 30 days from the date of submission of the application and no later than 15 December of the year of application. Enterprises that are approved to export under the quotas are issued a certificate of quota. After obtaining a certificate of quota, the exporter applies for the export licence, which must be issued by the relevant authority within three working days of receiving the application. The exporter then seeks export clearance from Customs by presenting the export quota licence to Customs for declaration and examination.

[1029] Order of the State Council No. 332, adopted at the 46th executive meeting of the State Council on 31 October 2001, effective 1 January 2002.
[1030] Order of the Ministry of Foreign Trade and Economic Cooperation No. 12, issued 20 December 2001, effective 1 January 2002.
[1031] Decree of the Ministry of Foreign Trade and Economic Cooperation No. 11, adopted on 20 December 2001, effective 1 January 2002.
[1032] Ministry of Foreign Trade and Economic Cooperation, Wai Jing Mao Mao Fa [2001] No. 626, issued 8 November 2001.
[1033] Ministry of Commerce and General Administration of Customs 2016 Public Notice No. 86, issued 30 December 2016, effective 1 January 2017.
[1034] Ministry of Commerce 2016 Public Notice No. 91 on Announcing the '2017 Graded License-Issuing Catalogue of Commodities Subject to Export License Administration' issued on 31 December 2016
[1035] Ministry of Commerce 2017 Public Notice N°68 on Announcing the '2018 Industry Products and Agricultural Products Export Quotas', issued on 30 October 2017.

China may also impose administrative or criminal sanctions for the unlawful exportation of goods subject to restriction, or for forging or altering import or export licences, quota certificates, or other documents. Under China's Regulation on Import and Export Administration, the holder of an export quota may be subject to reduction in the allocation of quotas for the following year for failure to return the unused quotas by 31 October of the year for which the export quotas have been issued; or subject to administrative sanctions for exporting without permission, exceeding the quantitative limitations, or buying or selling quota certificates or other documents without approval. Sanctions include revocation of the business licence for foreign trade and possible criminal punishment. Quota administering authorities that distribute quotas exceeding their authority may also be subject to sanction.

On 30 December 2016, MOFCOM and Customs published the 2017 Export Licensing Management Commodities Catalogue announcing those goods subject to restriction for 2017.

In directly allocating quotas, MOFCOM and the local administrative authorities are directed to take into consideration: (i) the export performance of the particular good; (ii) the utilization rate of the export quota; (iii) the business management/operation capacity of the applicant; and (iv) the '*production scale and resources status of the applicant enterprise or area'* during the previous three years.

The legal basis for selecting the products subject to export quota bidding are the Export Quota Bidding Measures which contain a broad variety of selection criteria, including goods that are '*non-renewable, staple-resource-type*' goods or goods '*well-positioned on the international market*' and upon the export volume of which the impact of price fluctuation is relatively little. In general, in order to participate in the bidding process, the enterprises must be: (i) qualified for engaging in export; (ii) registered with the business administration authority; (iii) members of the relevant chamber of commerce for import and export; and (iv) have exported or supplied for export volumes of the relevant commodity that '*reach […] a certain level.*'

The bidding price represents the amount per metric tonne that a bidding enterprise is willing to pay for the right to export. The bidding quantity is the amount of the relevant material the enterprise seeks to export. The bidding price and quantity, multiplied together, are used to determine the bid-winning price. China ranks all bids from enterprises in descending order, based on the bidding prices that are submitted. China then adds up the bid quantities proposed by the bidding enterprises in this descending list until the total quantity bid is equal to the total quantity of quota available. Those enterprises whose bid quantities are included in the total quantity of quota available are the winning bidders. The winning bidders are thus determined based on the highest bid prices.

Because of the imposition of export quotas, the markets of the products subject thereto and their downstream products are likely distorted.

12.4.3.3. NON-AUTOMATIC EXPORT LICENSING REQUIREMENTS

In case of certain goods, exporters must obtain prior approval of the government in the form of licenses or permits in order to export the product. This gives the government control over the exporters and the amounts of exported goods. Additionally, the required procedures might

generate extra transaction costs as well as hinder the exporters to react quickly to sales opportunities abroad due to long processing times. Non-automatic export licensing requirements are also referred to as export permits.[1036]

The OECD Inventory on export restrictions on industrial raw materials lists 102 items which were subject to licensing export requirements in 2014 (the newest data available currently), including aluminium, antimony, beryllium, cobalt, coke coal, rare earth metals, ferro-alloys, molybdenum, phosphates, nickel, silver, tantalum and titanium waste and scrap, tin, tungsten, vanadium, wood and other goods.[1037] The full list of materials subject to export licensing is published annually by MOFCOM in the Catalogue of goods subject to licensing.[1038]

12.4.3.4. STATE TRADING

Under the State trading provisions, only certain State Trading Enterprises ('*STEs*') can trade goods specified by the government (exports and imports). According to the WTO Trade Policy Review 2006 of China: '*The continued use of state trading to export these commodities allows the Government to influence their domestic (and export) price. Exports by STEs are determined taking into account both domestic and international demand and supply, and seek to maintain stable prices of "strategic" agricultural commodities, and ensure adequate supplies of inputs to state-run processing industries. Thus, the latter industries enjoy an implicit subsidy'*. [1039]

Under WTO rules member countries have to regularly notify WTO about their state trading enterprises.[1040] Since China has not submitted a notification between 2003 and 2014, in August 2014 the USA submitted a counter-notification on China's STEs listing 153 enterprises identified as engaging into state trading. This list included 44 additional enterprises, not listed in China's 2003 notification.[1041]

This prompted China to submit a notification on State trading to the WTO in 2015 (covering the period 2003-2014), according to which the following products are subject to state trading in exports:

[1036] OECD. (2014). *Export Restrictions in Raw Materials Trade: Facts, Fallacies and Better Practices* (OECD Publishing, 2014).
[1037] Inventory on export restrictions on Industrial Raw Materials, http://qdd.oecd.org/subject.aspx?Subject=ExportRestrictions_IndustrialRawMaterials (accessed on 10 October 2017).
[1038] The full list of products subject to licensing can be found in the catalogue: http://www.mofcom.gov.cn/article/b/c/201512/20151201225363.shtml (accessed on 10 October 2017).
[1039] WTO Trade Policy Review 2006, WT/TPR/S/161, page 170.
[1040] Paragraph 1 of the Understanding on the Interpretation of Article XVII of the General Agreement on Tariffs and Trade 1994 provides that '[i]*n order to ensure the transparency of the activities of state trading enterprises, Members shall notify such enterprises to the Council for Trade in Goods, for review by the working party.*' Paragraph 1 further states: '*Governmental and non-governmental enterprises, including marketing boards, which have been granted exclusive or special rights or privileges, including statutory or constitutional powers, in the exercise of which they influence through their purchases or sales the level or direction of imports or exports.*'
[1041] State trading counter-notification of the state trading enterprises of China pursuant to paragraph 4of the understanding on the interpretation of Article XVII, 7 August 2014.

> *In the products of which the export is currently subject to state trading administration, i.e. rice, maize, cotton, coal, crude oil, processed oil, tungsten, antimony and silver listed in Annex 2A2 of Protocol on the Accession of the People's Republic of China, as well as tobacco, rice, maize, cotton, coal, crude oil, processed oil and tobacco can only be exported by state trading enterprises, and no annual review of qualification of state trading of enterprises is needed. Tungsten, antimony and silver can only be exported by state trading enterprises […].*[1042]

China further explains that the '*quota license administration applies to the export of rice, maize, cotton, coal, crude oil, processed oil, tungsten, antimony and silver. Every state trading enterprise determines its export level within its licensed quota, according to market supply and demand, as well as prices and other factors*.' and that '*export prices of state trading enterprises are determined according to the prices of international market and the supply in domestic market, and by referring to the cost prices plus circulation expenses such as fees for warehousing, transportation, bank interests and inspection, etc.'*.[1043]

The submission by China resulted in additional questions by the USA with regard to transparency.[1044] The list submitted by the USA contains, on top of the products listed by China, kerosene, salt, indium, molybdenum and tin.[1045]

According to the WTO Trade Policy Review 2016, Chinese imports subject to state trading administration include: grain (including wheat, maize, and rice), sugar, cotton, chemical fertilisers, tobacco, crude oil, and processed oil. They can be imported only by authorized enterprises, in accordance with Article 11 of the Foreign Trade Law. With regard to exports, cotton, rice, maize, and tobacco are subject to state trading. These products, except for tobacco, are also subject to export quotas, which are managed by the NDRC and allocated only to state trading enterprises.[1046]

12.4.3.5. VAT REFUND WITHDRAWALS AND REBATES FOR PROCESSED GOODS

Another way of limiting exports of given products are VAT refund withdrawals. According to the OECD definition:

> *Most countries with a VAT system will rebate the VAT on exports. By denying VAT reimbursement in whole or part, it is less advantageous to export a product than to sell it domestically. This in turn encourages exports of products produced*

[1042] State Trading, New and full notification pursuant to Article XVII:4(A) of the GATT 1994 and Paragraph 1 of the Understanding on the interpretation of Article CVII, China, 2015.
[1043] Ibid.
[1044] See Miles, T. (2017) *China brushes off U.S. questions over state enterprises at WTO.* Reuters, available at: https://www.reuters.com/article/china-usa-wto/china-brushes-off-u-s-questions-over-state-enterprises-at-wto-idUSL2N1GT1ZH (accessed on 14 December 2017).
[1045] State trading counter-notification of the state trading enterprises of China pursuant to paragraph 4 of the understanding on the interpretation of Article XVII, 7 August 2014.
[1046] WTO Trade Policy Review 2016, WT/TPR/S/342, page 94.

locally that use the input to produce downstream products. A variant is the removal or reduction of rebate from other sales taxes on exports of a product.[1047]

According to the Notice of the Ministry of Finance and the State Administration of Taxation on the Policies of Value-added Tax and Consumption Tax Applicable to Exported Goods and Services:

Unless VAT export tax refund rates (hereinafter referred to as the 'Tax Refund Rate') have been specified by the MOF and the SAT pursuant to the decisions of the State Council, the Tax Refund Rates of exported goods shall be their respective applicable tax rate. The SAT shall, in accordance with the foregoing provisions, release the Tax Refund Rates through the database of Tax Refund Rates for Exported Goods and Services for compliance by both taxpayers and tax authorities.[1048]

By means of this Notice China is maintaining a policy of withdrawing VAT tax refunds for exports on specific items.[1049]

In a number of sectors there are full or partial VAT rebates on downstream products but not on the primary goods. This discourages the exports of unprocessed goods, artificially contributing to lower prices domestically (see the example of aluminium, Section 15.3).

12.5. PRICE SETTING

12.5.1. NDRC

Officially, the role of the NDRC with regard to pricing consists in regulating the overall price level and optimising major economic structures; formulating and implementing price policies; supervising and inspecting the implementation of price policies; setting and adjusting the prices of important commodities that are regulated by the State and important tariffs and charges; and according to relevant legislations investigating and dealing with price monopoly and activities that breach the price regulations.[1050]

Specifically, the Department of Price is the entity of the NDRC responsible for dealing with pricing issues.[1051]

[1047] See OECD. (2016). *Methodological note to the Inventory of Export Restrictions on Industrial Raw Materials*, page 4, Available at: http://www.oecd.org/tad/benefitlib/inventory-export-restrictions-ind.pdf (accessed on 10 October 2017)

[1048] Notice of the Ministry of Finance and the State Administration of Taxation on the Policies of Value-added Tax and Consumption Tax Applicable to Exported Goods and Services 财政部、国家税务总局关于出口货物劳务增值税和消费税政策的通知 财税[2012]39 号 http://www.chinatax.gov.cn/n810341/n810765/n812151/n812411/c1083252/content.html

[1049] For more information on the impact of VAT refund withdrawals see the example of aluminium (Section 15.3)

[1050] NDRC English website: http://en.ndrc.gov.cn/mfndrc/ (accessed on 10 October 2017).

[1051] Department of Price website: http://en.ndrc.gov.cn/mfod/200812/t20081218_252212.html (accessed on 10 October 2017).

Currently there are a few items in the Catalogue of Pricing by the Central Government, published by the NDRC. Items subject to price regulation relevant for the purpose of this report include natural gas, water supply for water conservancy projects and electricity (for energy, see Section 10.2.1.1).[1052]

Specific items subject to NDRC pricing include: oil and gas, water, as well as coal.

12.5.1.1. OIL AND GAS

In the past, the Chinese government used to set the retail price for refined petroleum products which often didn't keep pace with the price of crude oil. This effectively subsidised users of petroleum products, mostly in the industrial sector.[1053] According to new rules introduced in 2013, the prices of refined oil are adjusted by the NDRC whenever the international crude oil prices fluctuate by more than RMB 50 per tonne for a period of 10 working days. Therefore, domestic prices do not change if the price fluctuations in the international oil markets are below RMB 50. Furthermore, China has a ceiling of USD 130 per barrel, above which the price cannot rise, as well as a floor price of USD 40, which is the minimum price for China's refined oil. Due to this measure Chinese customers are to a certain extent cushioned from price fluctuations in international markets. It is also possible that prices are below or higher than international prices if international prices are below or above the floor or ceiling prices. The former has already happened once for a short period of time when the international price went below USD 40.[1054]

China is setting the gate station price for domestic onshore natural gas in all provinces, excluding the gas directly supplied for users (excluding the fertiliser enterprises who still pay the price set by the NDRC). The price of imported LNG and unconventional gas (shale, coalbed methane and synthetic natural gas) were fully liberalised in 2014.[1055] Previously, China used to set consumer prices for gas and petroleum products below international market rates. However a reform launched in 2011 ties the city-gate prices to the fuel oil and LPG market. This allows for a more market-based pricing.[1056]

In May 2017, the Central Committee of the Communist Party of China and State Council issued Opinions on Deepening the Reform of Oil and Gas System announcing a reform plan

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[1052] Other items include: special drugs and blood; important transportation services: railroad transportation services, civil aviation transport services, port services; important postal services; important professional services (basic services of commercial banks and service charges on bank card swiping). See Order No. 29 of the National Development and Reform Commission of the People's Republic of China – Catalogue of Pricing by the Central Government.

[1053] International Energy Agency. (2015). *China's energy sector reform*, Standing Group for Global Energy Dialogue, 23-24 September 2015.

[1054] The benefits from the difference between market rates and the price floor of USD 40 are set aside in a special account under State supervision, for funding investments in the energy sector. Source: *China's efforts to phase out and rationalise its inefficient fossil-fuel subsidies*. A report on the G20 peer review of inefficient fossil-fuel subsidies that encourage wasteful consumption in China. 5 September 2016.

[1055] Yang, J. (2014). *China's Natural Gas Price Reform Marches On*, IHS Energy, Energy Alert, p. 2.

[1056] *China's efforts to phase out and rationalise its inefficient fossil-fuel subsidies*. A report on the G20 peer review of inefficient fossil-fuel subsidies that encourage wasteful consumption in China. 5 September 2016.

for the Chinese oil and gas industry. According to this document, the market should play *'the decisive role in the sector in order to improve efficiency and competitiveness*'.[1057] The plan includes general provisions divided into eight key reform tasks, including provisions on gas exploration and mining, oil and gas import and export system, pipeline network, pricing, reform of the SOEs in the gas and oil sector and the resources reserve system. More detailed provisions are expected to be published before the end of 2017.[1058]

12.5.1.2. WATER

Since the 1980s, China has developed a comprehensive water pricing framework, which includes five fees and charges: the water resources fee, water supply tariff for hydraulic engineering, urban water supply tariff, wastewater collection and treatment tariff, and pollutant discharge fee.[1059]

The government of China seems to agree that the current pricing in China does not reflect the real cost.[1060] There are also academic sources pointing at too low water pricing in China, which in the global context can be seen as a competitive advantage and thus a distortion.[1061]

In the past, the European Commission established one instance of irregularities with regard to water. One of the two sampled exporters in the case on certain organic coated steel, Zhejiang Huadong Group, did not pay the full price for water supply normally applicable to the category of users to which it belongs, because it did not pay the sewage treatment fee.[1062]

[1057] Opinions on Deepening the Reform of Oil and Gas System, 中共中央 国务院印发《关于深化石油天然气体制改革的若干意见》 http://www.gov.cn/zhengce/2017-05/21/content_5195683.htm

[1058] See Spegele, B. (2017). *China Seeks More Private Money for Its Massive State-Owned Energy Companies*, Bloomberg. Available at: https://www.wsj.com/articles/china-seeks-more-private-money-for-its-massive-state-owned-energy-companies-1495422356 (accessed on 13 October 2017).

[1059] Dajun S. and Juan W. (2016). *State of the Art Review: Water pricing reform in China*, International Journal of Water Resources Development.

[1060] '*In China, almost all decision-makers and researchers have concluded that the water price is too low and is not useful for water resource allocation, protection and saving.'* See Dajun S. and Juan W. (2016): *State of the Art Review: Water pricing reform in China*, International Journal of Water Resources Development DOI: 10.1080/07900627.2016.1171743.

[1061] See for example Rutkowski, R. (2014). *The Economics of H_2O: Water Price Reforms in China*, Peterson Institute for International Economics, 22 July 2014, https://piie.com/blogs/china-economic-watch/economics-h2o-water-price-reforms-china: '*China's low water prices are pulling down the returns of water utilities and subsidizing water consumption. The average return-on-assets of Chinese water utilities over the past fifteen years have been too low to cover the cost of borrowing from banks, and even lower than the returns of electric power utilities. If water utilities aimed to make a profit high enough to cover the cost of their assets, they would have to raise water prices seven times higher than their current level. This would put Chinese water tariffs at levels closer to France or the United Kingdom. At current price levels the lost potential profit for water utilities should be viewed as a subsidy to water intensive users. For the past decade these subsidies averaged Rmb 25 billion a year*.'

[1062] Council Implementing Regulation (EU) No 215/2013 of 11 March 2013 imposing a countervailing duty on imports of certain organic coated steel products originating in the People's Republic of China.

12.5.1.3. COAL

In January 2017, China introduced a new system of governmental intervention into coal prices. The Notice on the Issuance of a Memorandum on Countering the Abnormal Price Fluctuations on the Coal Market jointly issued by the NDRC, China Coal Industry Association, China Electricity Council and China Iron and Steel Industry Association sets out a mechanism to limit coal price fluctuations. Thermal coal prices will be encoded by three colours, splitting the price fluctuation into three categories: up to 6%, between 6-12% and above 12% price difference. This resulted in 2017 in the following price ranges for these categories: for the green category between RMB 500 - 570 per tonne, for the blue category between RMB 570 - 600 or RMB 470 - 500 and for the red category in coal prices of above RMB 600 or below RMB 470 per tonne. In case the prices remain in the green area, the government will not take any measures. However, in case the price is in the blue zone, the government will strengthen market monitoring and, in due time, take necessary guidance measures and in case the prices fall into the red category, the government will trigger a response mechanism to counter abnormal fluctuations in the price of coal.[1063]

China's thermal coal price reached the limit of RMB 600 per tonne on in June 2017, exceeding the warning upper limit stipulated by the NDRC. In response, NDRC issued a document allowing coal mines with 'advanced capacity' (defined by several criteria, such as mechanization level, resource efficiency, production safety, energy consumption, environmental protection and product quality) to increase their production. The effectiveness of the policy remains to be seen.[1064]

With regard to power plants fired by coal, the NDRC decided to cancel the collection of the special funds for restructuring industrial enterprises and to cut 25% of the other surcharges levied on power enterprises. Profits for the coal fired power plants are thus expected to increase by roughly RMB 47.9 billon yearly. NDRC has also required local price bureaus to submit their plans on how to increase on-grid price paid to coal-fired power plants. In addition, following a State Council executive meeting held on 16 May 2017, lower desulfurization and denitrification fees are forthcoming. This will alleviate the pressure for power plants in this context of high coal prices.[1065]

[1063] See China Electricity Council website: http://www.cec.org.cn/xiangguanhangye/2017-01-13/163701.html (accessed on 12 October 2017)

[1064] Similarly, in February 2016, State Council instructed all mines nationwide to work no more than 276 days to eliminate overcapacity. 5 months later NDRC announced that mines with advanced capacity could switch back to 330 working days due to the resulting hike in coal prices.

[1065] See China Electricity Council website, 上网电价 7 月 1 日将变相上调 有望缓解火电亏损困局 (Disguised tariff increases shall occur as of 1st July for on-grid power. This shall hopefully ease losses and difficulties incurred by thermal power). http://www.cec.org.cn/xinwenpingxi/2017-06-22/169991.html

12.6. STOCKPILING

12.6.1. STATE RESERVE BUREAU

SRB, founded in 1953, is an agency under the NDRC. According to the official website:

> *The State Bureau of Material Reserve affiliated to NDRC is responsible for formulating national strategic material reserve strategy and plan, organizing collection, stockholding, utilization, replacement and day-to-day management of national strategic material reserve.*[1066]

The Bureau is responsible for managing strategic material reserves and managing funds, assets, infrastructure etc. It also manages trading in material reserves such as metals. Apart from a limited number of press articles, there is very little information with regard to the actions of SRB, the materials it purchases and the amount of products currently stockpiled. Apart from SRB, there are also a number of state agencies at the provincial level authorized to stockpile commodities. Their precise activities are even less known.[1067]

The SRB holds reserves of commodity metals (such as aluminium, copper, iron, tin), some technical metals (chromium, lithium, manganese, molybdenum, rare earth elements, selenium, tantalum, tungsten, vanadium, zirconium) and potash. There are also indications that the SRB may hold stocks of antimony, germanium,[1068] cadmium and cobalt.[1069] However, there is no official list of strategic commodities subject to stockpiling.[1070] The SRB decides on which raw materials and in what quantities will be stockpiled, depending on the forecast demand. There is no transparency of volumes and flows.[1071] The objective of stockpiling is to avoid price fluctuations and critical shortages.[1072]

The activities of the SRB can have a considerable impact on the prices as well as availability of certain materials in China and worldwide. In 2009 it was widely believed that the SRB purchased large amounts of **copper** (about 235 000 tonnes, accounting for 65% of copper

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[1066] See NDRC website: http://en.ndrc.gov.cn/mfod/200812/t20081218_252222.html (accessed on 10 October 2017).
[1067] There are indications that stockpiling is also authorised by the provincial governments and local warehouses keep stock of certain minerals to support metal prices in the domestic market, for example Jiangxi and Yunnan stockpile aluminium, copper, lead, rare earths, tungsten, and zinc and Inner Mongolia stockpiles rare earth concentrates. See for example "China's Quest for Resources" Testimony of W. David Menzie Chief, Global Minerals Analysis Section, National Minerals Information Center U.S. Geological Survey, https://www.doi.gov/ocl/hearings/112/ChinaMinerals_012612.
[1068] U.S. Geological Survey. (2014). *Mineral commodity summaries 2014*: U.S. Geological Survey, p. 196.
[1069] Menzie, W.D.,(2012). *China's Quest for Resources* Testimony of W. David Menzie, Chief, Global Minerals Analysis Section, National Minerals Information Center, U.S. Geological Survey, https://www.doi.gov/ocl/hearings/112/ChinaMinerals_012612 (accessed on 13 October 2017).
[1070] Hilpert H.G. and Mildner S.A. (2013). *Fragmentation or Cooperation in Global Resource Governance? A Comparative Analysis of the Raw Materials Strategies of the G20*, Stiftung Wissenschaft und Politik German Institute for International and Security Affairs, Bundesanstalt für Geowissenschaften und Rohstoffe (Berlin, Germany).
[1071] Ibid.
[1072] Ibid.

inventories held in London and Shanghai Exchange warehouses at that time[1073]), which helped keep the prices above a certain floor level.[1074] Also, it seems that in 2015 the SRB might have bought some 300 000 – 350 000 tonnes of copper, taking advantage of the lowest price in a six-and-a-half year period.[1075] According to different sources, the stockpile of SRB could be somewhere between 650 000 and 2 million tonnes of copper.[1076]

China is the largest consumer of **copper** globally, but with insufficient domestic resources it needs to import around 70% of its copper demand. The SRB purchases copper from foreign suppliers to put it on its strategic stockpile. In 2015 China added 600 000 tonnes of new smelter capacity with an additional 300 000 tonnes planned for 2016. Since the prices of copper fell by 25% in 2015, both the Chinese domestic smelting and mining industry started incurring losses. Therefore the announcement to buy 150 000 tonnes of copper by the SRB in 2016 could also be seen as a measure to support the domestic downstream and upstream copper industry, by temporarily boosting prices.[1077]

China planned in 2013 to purchase large amounts of **aluminium**, **zinc** and **nickel**. The news on planned purchases triggered a sharp rise in aluminium and zinc prices.[1078] China produces around 40% of global aluminium output. Therefore the announced purchase of 300 000 tonnes of aluminium seems more likely to be a measure to help destock the Chinese aluminium producers and thus support the Chinese metals industry rather than to secure aluminium supplies.[1079]

There are also reports of China purchasing 30 000 tonnes of **nickel** in 2013, which equals one sixth of the stocks in London Metal Exchange warehouses. The purchases have not been made public.

The purchases by the SRB of **germanium** also contributed to global price increases between 2012 and 2014, by limiting the quantities of germanium available on the market. As from 2014 the prices went down again, which could be partially attributed to the SRB finishing

[1073] Roache, S. (2012). *China's Impact on World Commodity Markets*. IMF Working Paper No. 12/115.
[1074] Financial Times. (2012). *Beijing set to buy up base metals*, 12.11.2012, https://www.ft.com/content/b56082b8-2cee-11e2-beb2-00144feabdc0 (accessed on 10 October 2017).
[1075] Net purchases could be lower due to stock rotation. See *GFMS Copper Survey 2016*, Thomson Reuters.
[1076] Metal Bulletin. (2015). *China's SRB revealed. Shedding light on the State Reserve Bureau*, A Metal Bulletin-Copper Price Briefing special report, https://www.metalbulletin.com/Article/3475883/Article.html (accessed on 10 October 2017).
[1077] Financial Times. (2016). *Beijing moves to support copper producers*, 6 January 2016, https://www.ft.com/content/880a753a-b48b-11e5-8358-9a82b43f6b2f (accessed on 10 October 2017).
[1078] Financial Times. (2012). *Beijing set to buy up base metals*, 12.11.2012, https://www.ft.com/content/b56082b8-2cee-11e2-beb2-00144feabdc0 (accessed on 10 October 2017).
[1079] Financial Times. *Beijing acts to stockpile aluminium*, 13 March 2013, https://www.ft.com/content/a2e98e9e-8be0-11e2-b001-00144feabdc0 (accessed on 10 October 2017).

purchases of germanium.[1080] According to USGS estimates, China held 30 tonnes of germanium in 2016.[1081]

SRB planned to purchase 10 000 tonnes of **antimony** for its National Stockpile in the second half of 2016.[1082] It also purchased **cobalt** in 2015 and 2016.[1083]

While the SRB purchases are not public, there are indications that SRB purchases metals only from restricted companies and that the main focus is on aiding large SOEs, such as Chalco.[1084] According to some sources, SRB is purchasing materials from three main domestic suppliers: China Minmetals Corp, Jiangxi Copper Corp and China North Industries Corp (Norinco) in China, as well as Glencore globally.[1085]

12.6.2. NATIONAL OIL RESERVE

In 2004, China started to build up strategic petroleum reserves ('SPR'). By mid-2016, China had stockpiled about 33.25 million tonnes under its SPR program,[1086] or roughly one month of net crude imports. Beijing's goal is to stockpile reserves amounting to 90 days of net imports, which is the standard for SPRs in most western countries.

12.6.3. STOCKPILING OF OTHER GOODS

12.6.3.1. COTTON

Beijing introduced cotton stockpiling in 2011, as a policy to maintain domestic cotton production and secure raw material supply to the domestic textile industry. This in turn lead to a significant increase in Chinese cotton prices, due to a cut in supply of the raw materials to the textile mills.[1087] In 2014, China stopped buying additional cotton, offering subsidies to cotton producers instead. The sales of cotton reserves by the State in 2014-15 resulted in an 8% drop in cotton prices, and a forecasted further 13% drop in 2015-16.[1088] In 2017 China

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[1080] U.S. Geological Survey. (2016) *Mineral commodity summaries 2016*: U.S. Geological Survey, 202 p., .https://minerals.usgs.gov/minerals/pubs/mcs/2016/mcs2016.pdf (accessed on 10 October 2017).
[1081] U.S. Geological Survey. (2017). *Mineral commodity summaries 2017*: U.S. Geological Survey, p. 25, https://minerals.usgs.gov/minerals/pubs/mcs/2017/mcs2017.pdf
[1082] Ibid.
[1083] Ibid.
[1084] Financial Times. (2012). *Beijing set to buy up base metals*, 12.11.2012, https://www.ft.com/content/b56082b8-2cee-11e2-beb2-00144feabdc0 (accessed on 10 October 2017).
[1085] Metal Bulletin. (2015). *China's SRB revealed. Shedding light on the State Reserve Bureau*, A Metal Bulletin-Copper Price Briefing special report, https://www.metalbulletin.com/Article/3475883/Article.html (accessed on 10 October 2017).
[1086] Global Times. (2017). *China needs to raise strategic oil reserve to ensure safe supply: experts*, published 2.5.2017 http://www.globaltimes.cn/content/1045046.shtml (accessed on 10 October 2017).
[1087] See Financial Times. (2014). *China abandons failed cotton stockpiling programme*, 20.01.2014, https://www.ft.com/content/5e0333ce-81a4-11e3-a600-00144feab7de (accessed on 10 October 2017).
[1088] See Financial Times. (2015). *Datawatch: Chinese cotton price*, http://blogs.ft.com/ftdata/2015/09/03/datawatch-chinese-cotton-price (accessed on 10 October 2017).

still holds large reserves of cotton.[1089] According to some accounts, those stockpiles amount to an estimated 60% of the world cotton stocks.[1090]

12.6.3.2. AGRICULTURAL COMMODITIES

China holds stocks of corn, wheat, rice and other agricultural commodities. The example of corn shows that the government policy of setting minimum prices above the market prices led, similarly as in case of cotton, to a creation of large corn reserves. In an attempt to tackle the problem of excessive corn reserves, China stopped setting corn price floors in 2016. China National Cotton Reserves Corp was merged with China Grain Reserves Corp, or Sinograin, in November 2016,[1091] and sales of stockpiles were announced.[1092] It seems that those measures however haven't brought significant results yet in terms of diminishing the stockpiles, as according to some estimates, China currently holds some 230 million tonnes of corn.[1093]

12.7. SHANGHAI FUTURES EXCHANGE

Shanghai Futures Exchange ('SHFE') was founded in 1999 with the merger of the Shanghai Metals Exchange (founded in 1992), the Shanghai Commodities Exchange and the Shanghai Cereals and Edible Oils Exchange. The SHFE is a closed exchange for Chinese-registered companies and Chinese citizens and it is controlled by the CSRC. The SHFE is currently inaccessible for foreign investors.

Currently, the following 14 commodities are listed for trading: copper, aluminium, zinc, tin, lead, gold, silver, steel rebar, steel wire rod, fuel oil, natural rubber, hot rolled coils, bitumen, nickel.[1094] The English version of Articles of Association & Rules of the SHFE also lists plywood and long-grained rice for futures contracts, though the corresponding Chinses version does not list these two commodities.[1095]

For the past few years there have been plans to open the crude oil market to foreign investors. Shanghai International Energy Exchange ('INE'), set up in the Shanghai Pilot Free Trade Zone in November 2013 under the SHFE, was supposed to launch officially in 2015. However, it is not operational to date. In May 2017, the INE officially released the INE

[1089] See Financial Times. (2017). *Cotton price rally goes 'pretty parabolic'*, 15.03.2017, https://www.ft.com/content/34bf621e-3851-11e7-821a-6027b8a20f23 (accessed on 10 October 2017).
[1090] See Financial Times. (2016). *China pledges to end corn stockpiling*, 29.03.2016, https://www.ft.com/content/15b0fb4a-f59e-11e5-803c-d27c7117d132 (accessed on 10 October 2017).
[1091] See Sina. (2016). 中储棉并入中储粮 两大公益类央企集合 http://finance.sina.com.cn/roll/2016-11-23/doc-ifxyasmv1628117.shtml (accessed on 10 October 2017).
[1092] See Financial Times. (2016). *China plans sale of corn stocks*, 26.05.2016, https://www.ft.com/content/19045678-2331-11e6-aa98-db1e01fabc0c (accessed on 10 October 2017).
[1093] See Financial Times. (2017). *China confronts issue of how to use up excess corn stocks*, 06.03.2017, https://www.ft.com/content/6d00c972-f28f-11e6-8758-6876151821a6 (accessed on 10 October 2017).
[1094] The last 3 are listed only in some instances on the SHFE's website.
[1095] See Part II, Chapter 2, Article 4: '*The Exchange lists futures contracts on copper, aluminium, natural rubber, plywood, long-grained rice, and may list other futures contracts as approved by the CSRC*.' Available at: http://www.shfe.com.cn/upload/20141210/1418200411012.pdf (accessed on 9 October 2017)

Articles of Associations, General Exchange Rules and 11 detailed rules and regulations concerning trading of crude oil. There are however no indications as to the exact date it would effectively start trading activities.[1096]

The previous investigations of the European Commission into aluminium products revealed a number of pricing irregularities with regard to the SHFE.[1097] The investigations revealed that the Chinese producers normally acquired raw materials in the Chinese market from local suppliers using Chinese spot market prices (or SHFE prices) as a benchmark. Since the aluminium prices in the SHFE were around 14-15% lower than the world market prices, Chinese operators benefitted from this price difference. Moreover, the Chinese companies could in theory also buy raw materials at London Metals Exchange ('LME') prices when prices in the Chinese market are higher, whilst the opposite is impossible for non-Chinese operators, since SHFE is only open to Chinese purchasers.

The investigations unveiled that several rules governing the functioning of the Exchange contribute to low volatility and depressed prices at the SHFE: daily price fluctuations are limited to 4% above or below the settlement price of the previous trading day, trading happens at a low frequency (until the 15th day of each month), futures contracts are limited to a duration of up to 12 months, and transaction fees are charged by both the Exchange and brokers. In addition, the State sets daily price limits via the rules of the SHFE which have been approved by the State Regulator, the CSRC.[1098]

Moreover, as concerns SHFE transactions, physical deliveries can only take place in an approved warehouse within the PRC, unlike international exchanges, where delivery can take place worldwide. SHFE is a platform for physical exchanges only (no derivatives are sold), which completely insulates the Chinese market for SHFE traded commodities. As a consequence the exchange works in isolation from other world markets, as arbitrage with the worldwide benchmark – the LME or other markets – is practically not possible. Thus, equalization among these markets cannot take place.[1099]

The investigations furthermore indicated that the State also intervenes with the price setting mechanisms in the SHFE as it is both a seller and a purchaser of primary aluminium via the

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[1096] Economic Daily: Shanghai International Energy Exchange Officially Released Rules and Regulations of Crude Oil Futures, available at: http://www.shfe.com.cn/en/AnnouncementandNews/SHFENews/911327704.html (accessed on 10 October 2017).

[1097] See Commission Regulation (EU) No 404/2010 of 10 May 2010 imposing a provisional anti-dumping duty on imports of certain aluminium wheels originating in the People's Republic of China; Council Implementing Regulation (EU) No 1039/2012 of 29 October 2012 imposing a definitive anti-dumping duty and collecting definitively the provisional duty imposed on imports of aluminium radiators originating in the People's Republic of China; Council Implementing Regulation (EU) No 1039/2012 of 29 October 2012 imposing a definitive anti-dumping duty and collecting definitively the provisional duty imposed on imports of aluminium radiators originating in the People's Republic of China.

[1098] Ibid.

[1099] Ibid.

SRB.[1100] As described in section 12.6.1, stockpiling by the SRB has an immediate effect on prices, which is then reflected in price fluctuations on the SHFE, and thus benefits the Chinese purchasers who can purchase raw materials cheaper than their foreign counterparts can.

12.8. PRESENCE OF SOES

The SOEs active in the commodities sector have a dual structure: on the one hand there are large SOEs with high productivity and a leading position in the world market and on the other hand a large number of smaller, privately or cooperatively owned companies with small output and low productivity. The most prominent examples of SOEs include Chalco (aluminium), Baosteel and Hebei Iron & Steel (steel), Jinduicheng (molybdenum), Baotou Steel & Rare Earth (rare earth elements), Yunnan Tin (tin), Zijin Mining (gol, copper, zinc) and Minmetals (metal trading).[1101]

China's SOEs represent a majority in the following raw material industries: mining and washing of coal (SOEs own 88% of assets in this industry), mining and processing of ferrous metal ores (60%), mining and processing of non-ferrous metal ores (67%), support activities for mining (97%), smelting and processing of ferrous metals (72%), smelting and processing of non-ferrous metals (61%), manufacturing of raw chemical materials and chemical products (52%), and production and supply of glass (87%).[1102]

12.8.1. ROLE OF SOES IN RARE EARTHS

China sets annual mining quotas for tungsten and rare earths, but also sets specific production goals for other commodities via other instruments, for example the 13th FYP. By setting a fixed production quota, China is able to control the supply of metals on the market and hence influence their prices.

In July 2017 MLR released the Notice on 2017 Rare Earth and Tungsten Mining Quota setting the total 2017 quota for rare earth mining at 105 000 tonnes, including 17 900 tonnes for ionic rare earths and 87 100 tonnes for rare earth ores. The total quota for tungsten concentrate is 91 300 tonnes, with 7 320 tonnes for mining quota and 18 100 tonnes for comprehensive utilisation.

The rare earth mining quota, broken down by provinces, gives:

- 59 500 tonnes of rare earth ore to Inner Mongolia

[1100] Ibid.
[1101] Hilpert H.G. and Mildner S A. (2013). *Fragmentation or Cooperation in Global Resource Governance? A Comparative Analysis of the Raw Materials Strategies of the G20* Stiftung Wissenschaft und Politik German Institute for International and Security Affairs, Bundesanstalt für Geowissenschaften und Rohstoffe (Berlin, Germany).
[1102] By assets, data for 2015 on the basis of the China Statistical Yearbook 2016, National Bureau of Statistics of China.

- 2 000 tonnes of ionic rare earths to Fujian
- 9 000 tonnes of rare earths to Jiangxi
- 2 600 tonnes of rare earth ore to Shandong
- 2 000 tonnes of ionic rare earths to Hunan
- 2 200 tonnes of ionic rare earths to Guangdong
- 2 500 tonnes of ionic rare earths to Guangxi
- 25 000 tonnes of rare earth ore to Sichuan
- 200 tonnes of ionic rare earths to Yunnan

Majority of the 2017 mining and smelting quotas were divided unevenly between six major SOEs:[1103]

- China Minmetals;
- Aluminium Corporation of China;
- China Northern Rare Earth Group High-Tech;
- Xiamen Tungsten;
- China Southern Rare Earth Group;
- Guangdong Rare Earth Industry Group.

Out of the batches of qualified enterprises that were published to date, most of them are affiliated with the above-mentioned six major SOEs. The quota is normally distributed by the six major SOE players across their provincial affiliated SOEs, who will then give quota towards lower level SOEs, private firms or Chinese-foreign joint ventures.

12.9. INVESTMENT RESTRICTIONS

One of the instruments to influence the level of supply is the steering of investment activities by the government, as explained in more detail in the investment chapter (see Section 8).

12.9.1. DOMESTIC INVESTMENT

The government of China limits investment into a number of businesses related to raw materials. According to the Notice of the State Council on Promulgating the Catalogue of Investment Projects Subject to Government Verification and Approval:

> *- Crude oil or natural gas (including coalbed methane) development projects shall be independently decided by enterprises with exploitation rights, and be reported to relevant industry management departments of the State Council for record-filing. Relevant enterprises with exploitation rights shall adhere to the principle of overall planning pursuant to applicable laws and regulations […]*

[1103] See the full list on the Ministry of Land and Resources website: http://www.mlr.gov.cn/zwgk/zytz/201707/t20170703_1523767.htm (accessed on 10 October 2017).

- Projects of iron and steel, electrolytic aluminium, cement, flat glass, vessels and other industries with serious overcapacity shall be strictly governed by the Guiding Opinions of the State Council on Addressing the Conflicts Caused by Serious Industry Overcapacity (Guo Fa [2013] No. 41). All regions and departments shall not process the record-filing of any project that adds new capacity in any other name or by any means

- Coal mine projects shall be strictly governed by the Opinions of the State Council on Resolving Overcapacity on the Coal Industry and Achieving Turnaround in Development (Guo Fa [2016] No. 7). In other words, the examination and approval of new coal mine projects, technological transformation projects that increase capacity and capacity verification and increase projects shall, in principle, be suspended for three years with effect from 2016. […]

12.9.2. FOREIGN INVESTMENT

On top of the above, the following raw materials are included in the 2016 Government approved investment project catalogue for foreign investors:

- Exploitation of rare earths, iron ore and non-ferrous metal mines: projects in this category shall be subject to verification and approval by provincial governments.

- Petrochemical: new ethylene, p-Xylene (PX) and methylene diphenyl diisocyanate (MDI) projects shall be subject to verification and approval by the provincial governments in accordance with the petrochemical industry planning and layout plan approved by the State; and the construction of new ethylene, p-Xylene (PX) and methylene diphenyl diisocyanate (MDI) projects not included in the relevant planning approved by the State shall be prohibited.

- Coal chemical: new coal to olefin projects and new coal-made p-Xylene (PX) projects shall be subject to verification and approval by the provincial governments in accordance with relevant planning approved by the State; new coal-based methanol with an annual output of over 1 million tonnes shall be subject to the verification and approval by the provincial governments; and construction of other projects shall be prohibited.

- Rare earths: rare earth smelting and separation projects and rare earth deep processing projects shall be subject to verification and approval by provincial governments.

- Gold: ore mining and dressing projects shall be subject to the verification and approval by provincial governments.

Foreign enterprises are obliged to follow the requirements of the Catalogue of Industries for Guiding Foreign Investment (2017 Revision), which sets out the following guidance:

Prohibited investment:

- Exploration and mining of tungsten, molybdenum, tin, stibonium and fluorite
- Exploration, mining and selection of rare earth elements
- Exploration, mining and selection of radioactive minerals
- Radioactive mineral smelting and processing, and nuclear fuel production

Restricted investment:

- Exploration and exploitation of oil and natural gas (including coal-bed methane, and excluding oil shale, oil sands, shale gas, etc.) (limited to Sino-foreign equity/cooperative joint venture operations)

- Exploration and mining of special and rare kinds of coal (with Chinese parties as the controlling shareholders)
- Exploration and mining of graphite
- Smelting and separation of rare earths (limited to Sino-foreign equity/cooperative joint venture operations), smelting of tungsten
- Purchase and wholesale of rice, wheat, corn

Encouraged investment:

- Mining Industry
- Exploration and exploitation of oil and natural gas, and utilization of mine gas
- Exploration, mining and ore dressing of minerals in acute shortage in China (such as leopoldite, chromite, etc.)
- Wood Processing and Wood, Bamboo, Rattan, Palm fiber and Straw Products, including one detailed subcategory
- Petroleum Processing, Coking and Nuclear Fuel Processing (1 subcategory)
- Manufacturing of Raw Chemical Materials and Chemical Products, divided into 17 subcategories
- Chemical Fiber Manufacturing, divided into 5 subcategories
- Rubber and Plastic Products, divided into 3 subcategories
- Nonmetallic Mineral Products, divided into 23 detailed subcategories, for example: *Production of raw materials for precision and high-performance ceramics: ultra-fine silicon carbide (SiC) powder (purity > 99%, average particle size < 1μm), ultra-fine silicon nitride powder (Si3N4) (purity > 99%, average particle size < 1μm), high-purity ultra-fine alumina powder (purity > 99%, average particle size < 0.5μm), low-temperature sintered zirconia (ZrO2) powder (sintering temperature 99%, average particle size < 1μm), rutile titanium dioxide (TiO2) powder (purity > 98.5%), white carbon black (particle size 99%, average particle size < 1μm)*
- Nonferrous Metals Smelting and Rolling Industry, divided into 2 subcategories, for example: *Production of new and high-tech nonferrous materials: compound semiconductor materials (gallium arsenide, gallium phosphide, indium phosphide and gallium nitride); high-temperature superconducting materials; memory alloy materials (titanium nickel, copper-based and iron-based memory alloy materials); ultra-fine (nano) calcium carbide and ultra-fine (nano) crystal hard alloy; ultra-hard composite materials; precious metal composite materials; combination of light metal composite materials and dissimilar materials; aluminum foils for radiators; medium- and high-voltage cathode capacitor aluminium foils; special large aluminium alloy sections;*

aluminium alloy precision forging dies; overhead conductors for electrified railway lines; ultra-thin copper strips; copper alloy materials for corrosion-resistant heat exchangers; high-performance copper-nickel and copper-iron alloy strips; materials for processing beryllium copper strips, lines, pipes and rods; high-temperature resistant and anti-senescence tungsten filaments; magnesium alloy castings; lead-free solder; magnesium alloys and their products; foamed aluminium; titanium alloy strips, titanium alloy smelting and processing; sponge zirconium at atomic energy level; and deeply processed tungsten and molybdenum products.

As can be seen from the examples above, the Chinese government has considerable investment restrictions in place with regard to investment projects relating to raw materials. This in turn has an impact on the structure of whole industry.

12.10. CHAPTER SUMMARY

China uses of a broad range of instruments allowing it to significantly influence the prices of raw materials. By artificially increasing or decreasing the level of raw materials supply, or simply by centrally setting the prices, the government can steer the prices upwards or downwards.

The dense web of plans – including plans at the sectoral, provincial and municipal level – regulates basically every aspect of the Chinese economy. In accordance with such plans, many key raw materials and other material inputs are to some extent regulated and are the targets of government intervention, as demonstrated in Section 3 of this chapter. Though this chapter looks primarily at national level plans, plans at provincial level are even more detailed, as shown by the example provided of Hebei province.

The system of plans setting very specific and detailed targets is the first source of distortion identified in this chapter. By defining in advance the quantitative production targets, the government can influence the level of supply of specific raw materials on the market. The Mineral Resources Development Plan sets out specific mining targets, whereas for more advanced goods the plans define production targets (for example the Hebei plan envisages targets such as an annual output of 400 000 tonnes of cold-rolled silicon steel or 9 570 of transparent oxide resistant membrane). Those targets are set out following a number of assumptions, such as a steady growth of the industry and demand for the given product, and in the end heavily affect supply and hence the prices. The governmental Plan also envisages controlling the overall mining volume, as is the case with rare earths. Whereas in normal market circumstances, the supply is a direct consequence of demand on the market, in China the supply and demand in many instances do not match. The 13th FYP for Mineral resources recognises that '*government interventions in resource allocation are still relatively numerous, the market principles applicable to mining rights are not comprehensive, the modern mining market system is not yet complete* […].' The non-ferrous metal industry development plan explicitly mentions '*mismatches between effective demand and effective supply'* as one of the main problems of the industry.

Other instruments applied in the plans which allow the government to influence the supply level as well as the industry in general include, but are not limited to: increasing supply of raw materials by setting detailed minimum production targets, decreasing supply by setting maximum targets, prescriptions over overcapacity e.g. by blocking new investment projects, interventions of the State into the structure of enterprises (mergers and acquisitions to create large enterprises), central management of the geographic distribution of industries and transfers, and various extensive support measures (financial and other).

Secondly, the government can influence prices by introducing different sorts of impediments to export. By limiting the quantities of raw materials exported abroad, the domestic supply is kept artificially high, leading to lower prices, constituting a benefit for the domestic producers of downstream products. Export restrictions are described in detail in Section 4.

Thirdly, the government of China has the capacity to set prices of certain goods centrally. Even though the list of centrally set prices has to a great extent been reduced, the government is still intervening in cases where the prices run counter to government policies. The example of newly introduced rules regulating the price of coal shows that the gradual price relaxation trend can be reversed at any time (see Section 5).

Stockpiling is another instrument allowing the State to significantly influence the domestic – and in some cases the global – raw material prices. Section 6 addresses the stockpiling of certain metals, including copper, nickel and tungsten, as well as cotton and agricultural commodities, and the major impact those reserves have on domestic and global prices. However, detailed information on stockpiling is not made public.

Section 7 describes how the stockpiling and the interventions by the State Reserves Bureau benefit the domestic producers due to the distortions of the Shanghai Futures Exchange benchmark prices.

Section 8 demonstrates that the industries relevant to the production of raw materials are to a large extent served by SOEs.

Finally, Section 9 shows that the State is guiding investments in the sectors examined. For some sectors there are investment restrictions, while for many sectors the government encourages investments. The State can back-up these restrictions and encouragements in a variety of ways, notably by granting (or refusing) financial support and when reviewing the various permits. All this allows the government to artificially influence the supply of specific goods.

13. LABOUR

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13.1. INTRODUCTION

Historically, the Chinese workforce was highly segmented, both on the geographic as well as the sectoral level. Workers were assigned to a geographic location by the *hukou* system and to a specific workplace through the '*danwei*' for urban residents and brigades ('*dadui*') for rural residents. The Chinese pre-reform employment system was clearly isolated from any market forces, with employees assigned to an SOE for a lifetime and wages set by the government. The centrally planned economy system also required a different institutional setting. Since labour-related issues were determined centrally, the Chinese trade union had no wage bargaining role, and no unemployment agencies or labour inspection were needed. The first reforms to the system fully controlled by the State were introduced in the 1980s, and in the intervening years, the Chinese labour system has greatly evolved, giving many more rights to workers with respect to compensation and choice of employment. However, remnants of the old system are still in place, such as the *hukou* system having an impact on the mobility of workers, lack of the explicit right to strike, as well as the lack of independent collective bargaining. All of these factors will be further analysed below.

13.2. LABOUR LAW

China abandoned the so-called 'iron rice bowl' cradle-to-grave social security system in the 1980s. The main labour regulations in China include the China Labour Law (promulgated in 1994, amended in 2009), as well as a set of three laws promulgated in 2007: Employment Contract Law (amended in 2012), Employment Promotion Law (amended in 2015), and Labour Disputes Mediation and Arbitration Law.

Other sources of labour law include:

- Law of the PRC on Assemblies, Processions and Demonstrations (1989), issued by the Standing Committee of the National People's Congress;
- Regulations on the Composition of Gross Wages (1990), issued by the National Bureau of Statistics;
- Trade Union Law (1992, amended in 2001);
- Circular on Several Issues Relating to Strengthening the Work of Trade Unions in Enterprises with Foreign Investment (1994);
- Provisional Regulation on the Payment of Wages (1994);
- State Council Regulations on Working Hours of Employees (1995);
  Regulations on Labour Protection in Workplaces Where Toxic Substances Are Used (2002). Issued by the State Council;
- Regulation on Labour Security Supervision (2004), issued by the State Council;
- Regulations on Minimum Wage (2004), issued by the Ministry of Labour and Social Security in 2004 (Decree No. 21 of the Ministry of Labour and Social Security);
- Regulation on Work-Related Injury Insurance (2003), issued by the State Council and revised in 2010;
  Ministry of Labour and Social Security Notice on Further Developing the Minimum Wage System (2007);
- Social Insurance Law (2010);
- Special Provisions on Labour Protection of Female Workers (2012);
- Opinions of the Ministry of Labour and Social Security on Several Issues concerning the Implementation of the Regulation on Work-related Injury Insurance (2013).

13.3. INTERNATIONAL LABOUR STANDARDS

International labour standards are legal instruments drawn up by the ILO's constituents (governments, employers and workers) and setting out basic principles and rights at work. They are either conventions, which are legally binding international treaties that may be ratified by member states, or recommendations, which serve as non-binding guidelines. Conventions and recommendations are drawn up by representatives of governments, employers and workers and are adopted at the ILO's annual International Labour Conference. Once a standard is adopted, member states are required under the ILO Constitution to submit them to their competent authority (normally the parliament) for consideration. In the case of conventions, this means consideration for ratification. If it is ratified, ratifying countries commit themselves to applying the convention in national law and practice and to reporting on its application at regular intervals.

Currently there are 71 conventions in force or have been recommended for ratification and active promotion. 23 of these conventions are in force in China.[1104]

The ILO has identified eight conventions as 'fundamental', covering subjects that are considered as fundamental principles and rights at work:

1. Freedom of Association and Protection of the Right to Organise Convention, 1948 (No. 87);
2. Right to Organise and Collective Bargaining Convention, 1949 (No. 98);
3. Forced Labour Convention, 1930 (No. 29);
4. Abolition of Forced Labour Convention, 1957 (No. 105);
5. Minimum Age Convention, 1973 (No. 138);
6. Worst Forms of Child Labour Convention, 1999 (No. 182);
7. Equal Remuneration Convention, 1951 (No. 100);
8. Discrimination (Employment and Occupation) Convention, 1958 (No. 111).

China did not ratify the former four. The latter four China ratified in 1990, 2006, 1999 and 2002, respectively.

Out of the four conventions not ratified by China, the two concerning freedom of association and the right to organise and collective bargaining are of special importance with regard to the existence of a labour market with equal rights attributed to employers and employees.

13.4. WAGES AND BENEFITS

An important instrument in China designed to influence wage trends in labour markets and ensure basic job-quality standards, especially for workers in a weak bargaining position, is the local minimum wage.[1105] China introduced first provisions on minimum wages in 1993 in the Regulations on Minimum Wages in Enterprises, with additional provisions in the 1994 Labour Law, the 2004 Provisions on Minimum Wages and 2007 Ministry of Labour and Social Security Notice on Further Developing the Minimum Wage System. In accordance with the Labour Law, the State has to implement a system of guaranteed minimum wages. The minimum wage can be fixed by provincial, regional or municipal governments and is reported to the State Council for the record. The Labour Law requires that wages paid to the labourers by employing units should not be less than the local standards on minimum

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[1104] For detailed list see: https://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:11200:0::NO::P11200_COUNTRY_ID:103404 (accessed on 15 November 2017).

[1105] There are also wage guidelines, however their role is unclear and they will not be discussed further: '*A second issue is the role of wage guidelines, which are based on surveys that often do not fully represent the local labor market, and in any event, play an unclear role in the discussions over wages at the firm level*.' See World Bank and the Development Research Center of the State Council, P. R. China. (2013). *China 2030: Building a Modern, Harmonious, and Creative Society*. Washington, DC: World Bank, page 323:

wages.[1106] Minimum wages in different regions are determined and adjusted with reference to the following factors: (i) living expense; (ii) the average wage level in the society; (iii) labour productivity; (iv) employment situation; and (v) different levels of economic development between regions.[1107]

Minimum wages vary considerably across different regions. Since their enactment, the minimum wages in China have increased by almost two and a half times between the mid-1990s and 2013.[1108] This growth was much slower than the real wage growth in urban units and, as a result, the gap widened between minimum wages and average wages in China over the past decade. [1109]

China's Minimum Wage Regulations implemented by the then Ministry of Labour and Social Security in March 2004, stipulate that each region should set its minimum wage at between 40% and 60% of the local average wage. However, very few provinces have reached that target with the average ratio of minimum to average wage at 27% in 2014 (ranging from below 20% to slightly above 40% in different provinces).[1110] This is notably lower than in OECD countries, where the average ratio of the minimum wage to average wage was close to 40% in 2014. Moreover, due to concerns in some regions of China that increases of minimal wages would decrease the competitiveness of the local businesses, the minimum wages in some regions have not been increased. For example Guangdong province imposed a two-year freeze on minimum wages in 2016.[1111]

Wages in the monopoly sectors (usually SOE dominated) are higher than in the competitive sectors. [1112] It has been argued that the wage premiums of SOEs reflect the underlying distortions in the operating environment of the enterprise and are not justifiable on grounds of efficiency or equity.[1113] Recruitment as well as salaries in SOEs are not market-lead, but rather follow the remnants of the former system. Explanatory Notes for the Third Plenum include provisions on improving SOEs policies with regard to labour: '[…] *SOEs should appropriately increase the proportion of market-oriented recruitment, and rationally*

[1106] Provisions on minimum wages (2004) Art 8 and 12.
[1107] Labour Law of China (1994), Art 49.
[1108] World Bank and the Development Research Center of the State Council, P. R. China. (2013). *China 2030: Building a Modern, Harmonious, and Creative Society.* Washington, DC: World Bank, p. 323.
[1109] ILO (2016). Wages, productivity and labour share in China http://www.ilo.org/wcmsp5/groups/public/---asia/---ro-bangkok/documents/publication/wcms_475254.pdf
[1110] OECD. (2010). *China's labour market in transition: job creation, migration and regulation* http://www.oecd-ilibrary.org/docserver/download/5kmlh5010gg7-en.pdf?expires=1512560260&id=id&accname=guest&checksum=15C5625024F3D7567BFF22A25DF5FA75 and OECD. (2017). OECD Economic Surveys: China 2017, OECD Publishing, Paris, p. 117. http://dx.doi.org/10.1787/eco_surveys-chn-2017-en (accessed on 15 November 2017).
[1111] OECD. (2017). *OECD Economic Surveys: China 2017*, OECD Publishing, Paris, p. 117. *http://dx.doi.org/10.1787/eco_surveys-chn-2017-en* (accessed on 15 November 2017).
[1112] World Bank and the Development Research Center of the State Council, P. R. China. (2013). *China 2030: Building a Modern, Harmonious, and Creative Society.* Washington, DC: World Bank, p. 320
[1113] Ibid., p. 325.

determine and strictly regulate the salary standards, position benefits, position related expenses and business spending of SOE management personnel'.[1114]

Chinese authorities report that 90% of enterprise employees among urban workers have signed labour contracts.[1115] However, based on the '*Investigation Report of the Chinese Migrant Workers 2016'* published by the National Bureau of Statistics in April 2017, only 35.1% of migrant workers in China had a signed labour contract with their employer, a 1.1% drop compared to year 2015,[1116] and were thus not legally entitled to the minimum wage nor covered by China's labour laws. Notwithstanding that, according to World Bank data, the compliance level seems high and currently almost all formal and informal workers in urban areas – whether migrant or local – receive labour income above the city-level minimum wage, and the minimum wage serves as a benchmark for enterprises in setting wages.[1117] However, the fact that many migrant workers (who make about 36% of China's total workforce[1118]) have no labour contract and are thus not covered by social protection insurance, constitutes a significant cost advantage for their employers.

Average labour taxation in China (45% marginal rate on income above RMB 80 000/month[1119]) is much higher than in other countries in the East Asian region and still higher than in most OECD countries. This leads to 'selective formalisation' of employment contracts in the formal sector and to a high rate of informal employment.[1120] Research in 2010 shows that having a labour contract is associated with wages that are 11% lower (due to social contributions, taxes etc.). Therefore, rural migrant workers as well as employers might have a preference to stay in the grey zone in order to receive higher benefits.[1121] A recent OECD

[1114] Explanatory Notes for Third Plenum, available at: http://www.china.org.cn/china/third_plenary_session/2014-01/16/content_31210122.htm (accessed on 13 October 2017)
[1115] See Ministry of Human Resources and Social Security's 2016 Report: http://www.mohrss.gov.cn/ghcws/BHCSWgongzuodongtai/201705/W020170531609020123750.pdf (accessed on 15 November 2017).
[1116] Investigation Report of the Chinese Migrant Workers 2016, http://www.stats.gov.cn/tjsj/zxfb/201704/t20170428_1489334.html
[1117] World Bank and the Development Research Center of the State Council, P. R. China. (2013). *China 2030: Building a Modern, Harmonious, and Creative Society*. Washington, DC: World Bank, p. 324.
[1118] According to the Human Resources and Social Security Statistics Report 2016 by MoHRSS, in 2016, the total number of rural migrant workers in China stood at 281.71 million and the total workforce was 776.03 million. http://www.mohrss.gov.cn/ghcws/BHCSWgongzuodongtai/201705/W020170531609020123750.pdf (accessed on 7 December 2017)
[1119] See MOF website, 财政部长详解个税改革"蓝图": http://www.mof.gov.cn/zhuantihuigu/2017ysbg/mtbd2017/201703/t20170308_2552344.html (accessed on 19 December 2017).
[1120] World Bank and the Development Research Center of the State Council, P. R. China. (2013). *China 2030: Building a Modern, Harmonious, and Creative Society*. Washington, DC: World Bank, p. 328
[1121] Gallagher, M., Giles, J., Park, A. and Wang, M. (2014). *China's 2008 Labor Contract Law: Implementation and implications for China's workers*. Human Relations, 68(2), pp.197-235, pp. 223-224

economic survey however finds that rural workers associate having a labour contract with higher wages, so the trend may have changed.[1122]

According to data of the National Bureau of Statistics, China's working age population started to decline for the first time in 2012 as the number of working-age Chinese declined by 3.45 million or 0.4%, accounting for 69.2% of the total population. In 2013 the drop continued down 2.4 million from a year earlier, accounting for 67.6% of the total population. In 2015 China's population declined by 4.87 million, which was the largest drop in the modern history of China.[1123] This coupled with the slowing migration of the rural population to the cities lead to labour shortages and contributed to wage increases.[1124]

13.5. COLLECTIVE BARGAINING OF WAGES BETWEEN LABOUR AND ENTERPRISES

As the level of wages is an important factor in the determination of the global cost of production, it is vital to establish whether they are undistorted. Market based wages should be understood as wages freely bargained between the workers and management in an undistorted economic environment.

In accordance with the Labour Law of 1994 and the Trade Union Law of 1992, a trade union may represent workers in negotiating and signing a collective contract with the enterprise on matters relating to labour remuneration, working hours, rest and vacations, occupational safety and health, insurance and welfare.

National laws concerning collective negotiations were first established in the 1992 Trade Union Law, followed by the 1994 Labour Law, the 1995 Regulations Governing Collective Contracts, the 2000 and 2001 Measures of Collective Wage Consultation, 2006 Comments Regarding the Development of Regional and Industry-based Collective Consultations, the 2008 Labour Contract Law, the 2009 ACFTU Guide on the Active Work of Collective Wage Negotiations, and the 2011 Provisions on Enterprise Labour Dispute Consultation and Mediation.

The 2008 Labour Contract Law requires employers to have consultations with trade unions or workers' representatives in making decisions on such matters as dismissal and redundancy (Article 41), and also in drafting or revising work and company rules (Article 4). Furthermore the provisions on collective contract negotiations give the employees of the enterprise the right to negotiate on an equal basis with the enterprise regarding matters relating to labour remuneration, working hours, rest and vacation, occupational safety and health, insurance and welfare (Article 51).

[1122] OECD. (2017), *OECD Economic Surveys: China 2017*, OECD Publishing, Paris, p. 117. http://dx.doi.org/10.1787/eco_surveys-chn-2017-en (accessed on 15 November 2017).
[1123] China Daily. (2016). *Working-age population sees biggest drop in modern history*. http://www.chinadaily.com.cn/china/2016-01/20/content_23158090.htm (accessed on 15 November 2017).
[1124] Rosen, D.H. (2014). *Avoiding the Blind Alley: China's Economic Overhaul and Its Global Implications*. New York: The Asia Society Policy Institute, p. 104.

ACFTU, officially founded in 1925, is China's only legally recognised trade union at the national level. The Trade Union Law, Article 2, provides that '*the All-China Federation of Trade Unions and all the trade union organizations under it represent the interests of the workers and staff members and safeguard the legitimate rights and interests of the workers and staff members according to law*.' Moreover, according to Article 11: '*the establishment of basic-level trade union organizations, local trade union federations, and national or local industrial trade union organizations shall be submitted to the trade union organization at the next higher level for approval*.' With such legal identity, trade unions are protected by law to engage in certain activities on behalf of workers, e.g. the signing of collective contracts with enterprises as described above. Since '*a trade union organization at a higher level shall exercise leadership over a trade union organization at a lower level*' (Article 9), ACFTU ultimately leads all legally recognized trade unions. For example, the establishment of a trade union and certain major matters – such as selection of its chairperson and vice-chairperson and committee members, and dissolution – are subject to approval of the higher level organisation.

China's trade unions are also subject to the leadership of CCP. According to Article 4 of the Trade Union Law, '*Trade unions shall […] uphold leadership by the Communist Party of China […]*' The Constitution of the Chinese Trade Unions (amended in 2013) also clearly states in its General Principles that '*Chinese trade unions are mass organizations of the working class under the leadership of the Communist Party of China, formed by the workers and staff members on a voluntary basis.*', and in Article 32 it states that '*trade union cadres shall: […] (2) execute the basic lines, guidelines and policies of the Party[…]*' In addition, the nomination and selection of the chairperson, vice-chairperson and committee members of the trade union must be approved by the Party organization at the same level.[1125]

ACFTU currently has some 288 million members and is present in 5 to 6 million enterprises. According to some sources, those numbers seem to be overstated, exaggerating the real bargaining power of the union and result from the local unions' goal to achieve a membership target numbers rather than from genuine trade union organising.[1126] According to the ILO Convention 87 (Freedom of Association and Protection of the Right to Organise Convention, 1948), to which China is not a signatory, all workers should have the right to establish and join organisations of their own choosing (Article 2) and elect their representatives in full freedom (Article 3(1)), and public authorities should refrain from any interference which would restrict this right (Article 3(2)). Moreover, the ILO Declaration on Fundamental Principles and Rights at Work, adopted in 1998, commits all ILO Member States to respect the main ILO principles and rights, including freedom of association.[1127] As noted above,

[1125] See Regulations on Election of Basic-level Trade Union Organizations, ACFTU, 9 October 2016.
[1126] Lee, C.H. (2009). *Industrial relations and collective bargaining in China*. In: ILO Working Papers.p. 12.
[1127] '*[A]ll Members, even if they have not ratified the Conventions in question, have an obligation arising from the very fact of membership in the Organization to respect, to promote and to realize, in good faith and in accordance with the Constitution, the principles concerning the fundamental rights which are the subject of those Conventions, namely: (a) freedom of association and the effective recognition of the right to collective*

however, ACFTU-affiliated trade unions are the only trade unions recognised by the State, and their leadership is subject to approval at by the Party and by the next higher level trade union organization. Therefore some observers see ACFTU as part of the Chinese state and not a voluntary association of workers as set out in International Labour Organization (ILO) Convention 87.[1128]

Since 2008 the government has increased its efforts to boost collective bargaining. The initiatives included a change in the role of the Ministry of Human Resources and Social Security ('MoHRSS') to support collective bargaining, the inclusion of collective contract negotiations into labour laws and the instructions of ACFTU to increase union organising and collective bargaining coverage (the so called 'Rainbow Plan''). [1129] First in 2008 and then again in 2014 collective bargaining was written into the central government's work report to the National People's Congress. In 2010, the ACFTU set a goal of achieving the so-called 'two universals' (liangge pubian): universal union membership and comprehensive collective bargaining coverage. In 2014, the ACFTU introduced a FYP (2014–2018) to promote collective bargaining.[1130]

Local governments also have an important role in promoting collective negotiations. For example, the Binhai new district in Tianjin provides firms with a subsidy equal to 15% of the total increase in wage bill resulting from collective bargaining.[1131] In 2009, 22 provinces had provincial regulations on collective bargaining adopted by the provincial people's congresses. These local regulations tend to offer more favourable legal environments for trade unions and collective bargaining developments. As from 2015, Guangdong has collective bargaining regulations in force which oblige employers to collectively bargain and also allow the direct election of worker representatives by workers (though the requirements of higher level regulations that such representatives must also be approved by the party organization and the trade union organization at a higher level are still in effect).

The Trade Union Law also provides a legal foundation for tripartite and bi-partite consultations at various levels to address labour issues. Tripartite Consultation Committees have been established across China to improve coordination among the three parties in the consultation process. They consist of representatives of the local government, the local ACFTU-affiliated trade unions, and the local branches of the China Enterprise Confederation ('CEC') and China Enterprise Directors Association ('CEDA') (who together represent the

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bargaining; […]' ILO Declaration on Fundamental Principles and Rights at Work and its Follow-up Adopted by the International Labour Conference at its Eighty-sixth Session, Geneva, 18 June 1998 (Annex revised 15 June 2010), Article 2

[1128] Lee, C.H., Brown, W. and Wen, X. (2016). *What Sort of Collective Bargaining Is Emerging in China*? British Journal of Industrial Relations, pp 216-236, p. 233.

[1129] Kuruvilla, S. and Zhang, H. (2016). *Labor unrest and incipient collective bargaining in China.* Management and Organization Review, 12 (1). pp. 159-187, p. 9.

[1130] See 中华全国总工会关于印发,《中华全国总工会深化集体协商工作规划(2014-2018 年)》的通知 http://www.shzgh.org/renda/node5902/node5911/node6581/u1a6019251.html (accessed on 15 November 2017).

[1131] Kuruvilla, S. and Zhang, H. (2016). *Labor unrest and incipient collective bargaining in China.* Management and Organization Review, 12 (1). pp. 159-187, p. 15.

interests of enterprises). The CEC and CEDA are the only officially designated employers' organisations at the national level in China. Under these circumstances, given the official status of each of the parties involved in the tripartite consultations, in the literature the consultation process has been described as a 'multi-headed monologue'.[1132] However, there are also signs of growing divergence among the three parties.[1133]

The freedom of association and the right to strike are fundamental conditions to arrive at equitable labour market outcomes.[1134] But whether Chinese workers have the right to strike is a debatable point. Since the right to strike was removed from the Chinese constitution in 1982, no other laws or regulations have explicitly permitted such right. However, the Trade Union Law as well as some local regulations do recognize that work stoppages may occur under some circumstances. According to Article 27 of the Trade Union Law, '*In case of stoppage or slowdown in an enterprise or institution, the trade union shall, on behalf of the workers and staff members, hold consultation with the enterprise or institution or the parties concerned, present the opinions and demands of the workers and staff members, and put forth proposals for solutions*.' On the local level, the Shenzhen legislature, for example, passed regulations on the promotion of harmonious labour relations in 2008 which essentially mirror the provisions of the Trade Union Law on this issue. The absence of official recognition of the right to strike, however deprives the workers of an important instrument of collective pressure in a deadlock situation, further weakening their position.[1135]

With respect to freedom of association, Article 35 of China's constitution explicitly provides for freedom of assembly and association. However, as described above, such freedom is not in fact available to employees wishing to create their own workers representation, and the Trade Union Law requires them to turn to ACFTU.

In February 2016 the International Trade Union Confederation filed a complaint at the ILO Committee on Freedom of Association against the Chinese government following the detention of labour activists in a coordinated police action in Guangdong province in December 2015. The interim report of 2016 states that the activists '*appear to have been arrested, detained and charged for being involved in a labour dispute and considers that the detentions of persons connected with their activities in defence of the interest of workers constitutes a serious interference with civil liberties in general and with trade union rights in particular*'. [1136] The ILO Committee on Freedom of Association found in a number of instances that even though there are provisions in the constitution guaranteeing freedom of association, many provisions of the Trade Union Law were contrary to the fundamental

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[1132] Lee, C.H. (2009) *Industrial relations and collective bargaining in China*. In: ILO Working Papers.p. 9.
[1133] Ibid.
[1134] Ibid.
[1135] Ibid.
[1136] See ILO Case No 3184, Report 380, para 236. Available at: http://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:50002:0::NO::P50002_COMPLAINT_TEXT_ID:3302077 (last accessed on 19 December 2017).

principles of freedom of association[1137] and thus the workers cannot take advantage of this formal right in practice.

Despite a number of written laws that have been promoting collective bargaining, a significant hurdle in the practical implementations of those provisions is the lack of a detailed legal framework and procedures.[1138] Another factor adding to the difficulty in collective bargaining is the fact that the gap in negotiating power of the enterprise and employee is very big, with both the public and private enterprises having much more power than the employees.[1139]

Historically, workers often have not turned for help to the union, because the unions have often been seen as relatively incompetent or incapable to act on the workers' behalf.[1140] A survey found that whether a union existed or not at the workplace did not make any difference in wages and other working conditions.[1141]

The ineffectiveness of unions has partly been due to their lack of independence. Deep incorporation of trade unions into the formal state structure gives the State direct control over trade unions.[1142] Trade union chair posts are occupied by senior party figures in SOEs or by managers in non-state enterprises. Even in companies consisting largely of unskilled workers, the trade union leadership usually comes from the higher management. Trade unions where leaders are actually managers are clearly unable to perform the role of workers' representation in an enterprise.[1143] Nevertheless, union leadership appointed from high ranking political posts has also had a positive effect on the shaping of labour laws and regulations, since the trade unions have stronger political influence on the legislative and decision making process, especially in view of the strong business lobby in China.

Even though in the past the trade unions in the form of ACFTU served mainly as a transmission channel for state policy and as the administrators of welfare at the workplace, by the early 2010s China had developed a new range of market institutions.[1144] ACTFU historically negotiated collective contracts that largely repeated statutory duties. However, recently it seeks to engage in collective negotiations and is becoming more effective in securing benefits such as higher wages, shorter working hours, and better insurance coverage

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[1137] See Case No 3184, Report 380, para 233; Case No. 2031, Report 321, para 165; Case No. 1652, 286 Report; Case No. 1930, Report 310.
[1138] Brown, R. (2015). *Collective bargaining in China: Guangdong regulation a harbinger of national model?* China EU Law Journal, Volume 4, Issue 2, pp 135-154, p. 141.
[1139] Ibid.
[1140] Taylor, B. and Li, Q.(2007). *Is the ACFTU a union and does it matter?* in Journal of Industrial Relations, Vol.49, No.5, p. 709.
[1141] Lee, C.H., Brown,, W. and Wen, X. (2016). *What Sort of Collective Bargaining Is Emerging in China*?, British Journal of Industrial Relations, pp 216-236, p. 221.
[1142] Lee, C.H. (2009). *Industrial relations and collective bargaining in China*. In: ILO Working Papers.p. 16.
[1143] Ibid.
[1144] Lee, C.H., Brown, W. and Wen, X. (2016) *What Sort of Collective Bargaining Is Emerging in China*?, British Journal of Industrial Relations, pp 216-236, p. 215.

in some localities.[1145] It seems that recently there is slowly rising acceptance of ACFTU, as it has begun, at least at some local levels, to take a more progressive approach towards advocacy and started some attempts on democratisation of union leadership.[1146] In order to increase its effectiveness, ACFTU issued new directives and committed funds of RMB 10 million to build the expertise of union negotiators, as well as set up negotiation committees throughout China to support collective negotiation activities.[1147] There are claims that in 2012 some 145 million workers were covered by 1 310.100 collective contracts countrywide covering 88.4% of all enterprises in the country.[1148] According to ACFTU data, in September 2014 there were a total of 2 524 million collective contracts covering 6 864 million enterprises and[1149] according to MoHRSS there were 1.91 million registered collective contracts covering 178 million workers.[1150]

Furthermore, even though there is no officially recognised right to strike, there is evidence that the labour unrest in China is growing, especially with a growing number of strikes and other collective actions taken by the workers since 2008, often with positive outcomes for the workers. The bargaining power of the Chinese workers has been strengthened by the strong labour legislation issued in the 2000s and by labour shortage.[1151] An example is a series of strikes at auto parts suppliers that led to high wage increases exceeding 20% at Honda plants.[1152]

The 13th FYP includes provisions on further developing collective bargaining: '*Efforts shall be made to improve the scientific determination mechanism, normal growth mechanism, payment guarantee mechanism; to promote collective salary negotiation in enterprises; and to improve the minimum wage growth mechanism.*'[1153]

13.6. LABOUR MOBILITY AND ITS IMPACT ON WAGES

Historically, China used to have a rigid population registration system which separated the population into the rural and urban areas. The household registration system, the so-called *hukou* system, largely divided the society between urban *hukou* holders with access to social

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[1145] Lee, C.H. (2009) *Industrial relations and collective bargaining in China*. In: ILO Working Papers.p. 17.
[1146] Brown, R. (2015). *Collective bargaining in China: Guangdong regulation a harbinger of national model?* China EU Law Journal, Volume 4, Issue 2, pp 135-154, p. 138.
[1147] Ibid.
[1148] Ibid., p. 139 quoting 2012 Annual Human Resources and Social Security Enterprise Development Statistical Bulletin.
[1149] See ACFTU website, 立法，让职工敢谈老板愿谈 http://acftu.people.com.cn/n/2015/0309/c67583-26662059.html (last accessed on 19 December 2017).
[1150] Ministry of Human Resources and Social Security, Human Resources And Social Security Statistics Report 2016. http://www.mohrss.gov.cn/ghcws/BHCSWgongzuodongtai/201705/W020170531609020123750.pdf (accessed on 5 December 2017).
[1151] Kuruvilla, S. and Zhang, H. (2016). *Labor unrest and incipient collective bargaining in China.* Management and Organization Review, 12 (1). pp. 159-187, p. 3.
[1152] Ibid., p. 8.
[1153] 13th FYP, Chapter 63.

security and public welfare and rural residents with access to land, but no or limited access to the social benefits outside of their formal registered birthplace as stated in the *hukou*.

The issuing of Regulations on Household Registration of the People's Republic of China in 1958 formally established the *hukou* system which restricted migrations between rural and urban areas and across regions. The system was modelled after the Soviet style internal passport and had the official objective of 'consolidation of the socialist system and public interests'.[1154] As described by the World Bank:

> *[…] anyone at birth should be registered in the locality where his or her mother is registered, and has little chance to change this registration locality in his or her entire life. In practice, residential movement across localities was controlled by the departments of public security. It was impossible for rural residents to move to cities without official approval. Labor mobility across sectors was planned by the departments of labor and personnel and no independent labor market was allowed. During the period from the 1950s to the onset of reform, the hukou system was strictly enforced and effectively prevented labor from migrating from rural to urban areas.*[1155]

Reforms since the late 1980s largely eliminated the mobility restriction function of *hukou*.[1156] In 1984, the government introduced a system of temporary residence permits that allowed rural *hukou* holders to move to the cities. This resulted in more than 60 million migrants coming to the Chinese cities in the first 10 years after the reform. The 12th FYP released in 2011 for the first time specifically mentioned household registration reform in a standalone chapter on urbanization. The 'New Urbanisation Programme' was introduced at the 18th National Congress of the Communist Party of China in November 2012, and in July 2014 the State Council introduced a single national resident registration system (*jumin hukou*) for both rural and urban populations, which is to be established by 2020.[1157]

The new registration system maintains the principle of population control and encourages rural migrants to settle down in smaller and migrant small cities, keeping the criteria for gaining residency in the most popular destination cities for migrants still prohibitively strict.[1158] There are different rules on obtaining a *hukou* depending on the size of the city. The

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[1154] Decree of the President of the PRC, Zhonghua renmin gongheguo hukou dengji tiaoli (Regulations on Household Registration in the PRC), January 9, 1958, in Chan, K. W. and Zhang, L. (1999)."The hukou system and rural-urban migration in China: Processes and changes", Center for Studies in Demography and Ecology of the University of Washington, The China Quarterly 160 (1999): 818-855.
[1155] World Bank. (2005). *China - Integration of national product and factor markets : economic benefits and policy recommendations*. Washington, DC: World Bank. p.73.http://documents.worldbank.org/curated/en/812981468025215645/China-Integration-of-national-product-and-factor-markets-economic-benefits-and-policy-recommendations (last accessed on 19 December 2017).
[1156] World Bank and the Development Research Center of the State Council, P. R. China. (2013). *China 2030: Building a Modern, Harmonious, and Creative Society*. Washington, DC: World Bank, p. 330.
[1157] See the circular of the State Council 国务院关于进一步推进户籍制度改革的意见
[1158]OECD. (2017). *OECD Economic Surveys: China 2017*, OECD Publishing, Paris, p. 117. http://dx.doi.org/10.1787/eco_surveys-chn-2017-en (last accessed on 10 October 2017).

largest cities ('megacities') have the most prohibitive rules, which gradually become less strict according to the size of the city. A circular of the State Council indicates that in the large and super cities, different *hukou* policies should be created for downtown areas, suburbs, and new districts according to occupation, residence, participation in social security, and years stayed. Medium and large cities should not set barriers on *hukou* for house purchasing, investment, or tax payment. Cities with a downtown permanent population below 3 million should not implement the credit-based *hukou* system.[1159]

It is still very difficult for migrant workers to get an urban *hukou* for the largest cities, where the public goal is to limit the rural population influx. As an example, Beijing is expected to keep the population level below 23 million permanent residents by 2020. In 2016 the Beijing municipal government issued a new policy on granting *hukou* using an accumulated points system based on a number of merits.[1160] The points system in practice makes it impossible for workers with the lowest qualifications (the least paid workforce) to obtain a *hukou*.

Notwithstanding the fact that obtaining a *hukou* in large cities is still very difficult if not impossible, moving between rural areas and towns is much easier currently than it used to be before the reform. According to MoHRSS, there were 281.71 million migrant workers in 2016 in China.[1161] The data of the National Bureau of Statistics of China indicates that the number of rural migrant workers in 2015 totalled 277.47 million, so the number of migrants grew by 4.24 million between 2015 and 2016.[1162] In 2015, China's State Council announced that by 2020 it would grant permanent urban residence permits to 100 million urban workers. According to a circular of the State Council issued in October 2016, the urbanization rate of household registered population should rise on average by 1% each year, or more than 13 million people, during the 13th FYP period (2016-2020).[1163] This however still means that less than half of the current migrant workers will be covered by the plan.

Since the announcement of the reform, the government has made considerable progress on its implementation. China's Ministry of Public Security announced that in 2016 it had issued

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[1159] See State Council website, *China to resolve hukou issue for 100 million rural migrants*. http://english.gov.cn/policies/latest_releases/2016/10/11/content_281475463620362.htm (accessed on 24 August 2017).
[1160] Beijing Today. (2016). *City Published Accumulated Points Plan for Hukou* https://beijingtoday.com.cn/2016/08/city-published-accumulated-points-plan-hukou/ (accessed on 24 August 2017).
[1161] See footnote 1118.
[1162] China's Economy Realized a Moderate but Stable and Sound Growth in 2015, National Bureau of Statistics of China, 19 January, 2016 http://www.stats.gov.cn/english/PressRelease/201601/t20160119_1306072.html (accessed on 24 August 2017).
[1163] See State Council website, *China to resolve hukou issue for 100 million rural migrants*. http://english.gov.cn/policies/latest_releases/2016/10/11/content_281475463620362.htm (accessed on 24 August 2017)

28.9 million new urban residency permits, with 1.69 million issued in Beijing, 406 000 in Shanghai, 810 000 in Guangzhou, and 1.71 million in Shenzhen.[1164]

Even though there are no more formal restrictions on mobility *per se* and workers can relocate freely, migrant workers who do not possess a local *hukou* continue to have difficulties obtaining access to education for their children, health care, pension, welfare and affordable housing in their place of place of work.[1165] Those restrictions in practice are a factor discouraging or effectively hindering workers' mobility across China.

The migrant workers' income is still lagging behind the average urban income. According to the National Bureau of Statistics of China, the average monthly income of migrant workers in 2015 was RMB 3 072, up by 7.2% compared to 2014.[1166] At the same time the average wage of persons employed in urban units was around RMB 5 169 monthly.[1167] Research by China Development Research Foundation points to a minimal impact of the *hukou* status on this differential attributing only 5% of the wage difference to *hukou* (down from 11% in 2001).[1168] The other factors responsible for wage differences include difference in education, skills and other work related qualifications. According to some data, average wages of migrant and local workers appear to be converging rapidly, indicating that the labour market is slowly converging to a system based on demand and supply.[1169]

In the late 1990s, migrant workers accounted for 70-80% in the special economic zones[1170] and in 2011 they still represented the absolute majority of the workforce in manufacturing, construction and basic services (cleaning, restaurants).[1171] By providing a massive supply of low-cost labour, migrant workers contributed significantly to the Chinese extensive growth model.[1172] The current structure is definitely changing and gradually converging with

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[1164] See China's Government Website, 图表：推行居住证制度 去年发放居住证 2890 余万张, http://www.gov.cn/xinwen/2017-02/11/content_5167328.htm (accessed on 24 August 2017).
[1165] World Bank and the Development Research Center of the State Council, P. R. China. (2013). *China 2030: Building a Modern, Harmonious, and Creative Society.* Washington, DC: World Bank, p. 331.
[1166] See National Bureau of Statistics website, (2016). *China's Economy Realized a Moderate but Stable and Sound Growth in 2015* http://www.stats.gov.cn/english/PressRelease/201601/t20160119_1306072.html (accessed on 24 August 2017).
[1167] While the NBS issues a relatively clear set of data on migrant wages every quarter, their data on urban wages are far from being straightforward. A possible way is to use their annual urban unit data. However, urban unit employment is a narrow (and more formalized) subset of urban employment and account only for about a half of urban employment. The urban average wage was calculated by dividing the annual figure of RMB 62 029 by twelve. This gives RMB 5 169, but the actual figures are probably lower.
[1168] China Development Research Foundation. (2013). *The Turning Period of China's Income Distribution: An Impact Assessment on Income Distribution-related Policies in China* (Executive Summary), p.5. http://www.cn.undp.org/content/china/en/home/library/poverty/executive-summary--the-turning-period-of-china-s-income-distribu.html (accessed on 24 August 2017).
[1169] World Bank and the Development Research Center of the State Council, P. R. China. (2013). *China 2030: Building a Modern, Harmonious, and Creative Society.* Washington, DC: World Bank, p. 328.
[1170] Rothman, A. and Zhu J. (2013). *Hukou reform. Household registration revamp to drive growth*, CLSA Asia-Pacific markets, China Macrostrategy, May 2013.
[1171] International Labour Organization, Promoting Decent Employment for Rural Migrant Workers, ILO, 2011.
[1172] Das, M and N'Diaye, P. (2013). *Chronicle of a Decline Foretold: Has China Reached the Lewis Turning Point?* IMF Working Paper No. 13/26, Research Department and Asia and Pacific Department, page 3.

internationally recognised labour standards, though it seems that at the moment the system is still partly impacted by the distortions of the past.

The National Bureau of Statistics published in April 2017 its annual report on the composition and characteristics of China's migrant workers (formally rural workers who don't perform agricultural labour).[1173] The growth of this category of population is slowing, standing at 281 million in 2016, up 1.5 % year-on-year (it has been below 2% for 3 years in a row). They are getting older, but also more educated, as well as less mobile. The age of a massive cheap labour reservoir moving around the country seems to have reached its end and the changing profile of the workforce creates the conditions for a gradual movement up the value chain for the country's industry. Although a majority continue to work in the industrial sector (53%), the share of those working in the services sector is growing rapidly: from 44.5% in 2015 to 46.7% in 2016, reflecting changes in the overall economy. Even today, only a third of these migrant workers sign contracts with their employers, a share that is actually shrinking, leaving them without basic protections, especially in the construction and services sectors.

13.7. LAW ENFORCEMENT

Chinese labour regulations are relatively strict. With regard to the 2008 Labour Contract Law, using the Employment Protection Legislation ('EPL') strictness applied to OECD countries, China would rank third in EPL strictness among OECD countries after full implementation.[1174] However it is necessary to look at the compliance rate to understand the practical implications of the written laws.

The subjective assessments of workers and firm managers suggest that the compliance rate is high and that the government has made a serious effort to implement the new Law.[1175] It seems that the enactment of the Labour Contract Law indeed puts a stronger burden on employers, as according to some accounts, some labour-intensive manufacturers decided to relocate out of China after the law came into force. For example numerous manufacturers in Guangdong moved their production to other countries such as Vietnam and Burma, where labour was cheaper and legally less protected, and Wal-Mart reportedly dismissed a number of white-collar employees in 2007 to minimize the impact of the new law. [1176]

The 2008 Labour Contract Law also positively influenced the labour market with an increase of more 20% for labour contract coverage of migrant workers between 2005 and 2010 (from 12% to 34% including all types of employment). For migrant wage workers only,[1177] the share

[1173] National Bureau of Statistics website (2017). 2016 年农民工监测调查报告 http://www.stats.gov.cn/tjsj/zxfb/201704/t20170428_1489334.html (accessed on 10 October 2017).
[1174] Gallagher, M., Giles, J., Park, A. and Wang, M. (2014). *China's 2008 Labor Contract Law: Implementation and implications for China's workers*. Human Relations, 68(2), pp.197-235, p. 199.
[1175] Ibid., p. 201-206.
[1176] Wang, H., Appelbaum, R.P., Degiuli, F. and Lichtenstein, N. (2009). *China's New Labour Contract Law: is China moving towards increased power for workers?*, Third World Quarterly, 30:3, 485-501, p. 488.
[1177] The number is lower when including non-wage migrant workers, see Section 13.4.

with labour contracts increased from 37% in 2005 to 60% in 2010 and 51% of wage earning rural migrants had labour contracts by 2010.[1178] However there is also analysis showing that the increase in collective agreements can be partly explained by bureaucratic competition to meet targets, rather than by a real increase in collective bargaining, since a lot of the contracts simply replicate the minimum legal conditions and the collective bargaining process often lacks the genuine process of negotiation. In fact, while the number of workers covered by general collective agreements has risen, the number of workers covered by specific wage agreements has grown at a slower pace.[1179]

Since enactment of the Labour Contract Law, the employers tried evading the legal requirements in several ways. One element was the rise in labour subcontracting (13.1% according to ACFTU). Subcontracted workers, even though in possession of a formal contract, typically have lower wages, lower social insurance and less security.[1180] Another practice was not to respect the provisions of the contract, for example with respect to the number of working hours and wages. Some sources point to workers being forced to sign blank contracts or contracts drafted in languages they couldn't understand.[1181] Other sources point to an increase in practices avoiding minimum wage provisions, for example by raising canteen prices or employees' fines for any insubordinations in order to offset wage increases.[1182] An example involves Huawei, which in 2007 and 2008 reportedly pushed 7 000 employers to resign and sign new contracts to evade the requirement of entering into open-ended labour contracts if employees have been working for the employer for a consecutive period of 10 or more years.[1183] Due to the lack of statistical evidence in China, there is no data to clearly establish whether such practices are unusual or if relatively common.

The labour dispute resolution system, introduced in the 1994 Labour Law, provides for a three step system beginning with voluntary mediation, followed by compulsory arbitration and finally ending with appeals of the arbitration decision in civil courts.[1184] Between 1995 and 2007, labour disputes increased on average by about 25% annually, and in 2008 arbitrated labour disputes almost doubled nationally.[1185] In seven provinces labour disputes increased by

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[1178] Gallagher, M., Giles, J., Park, A. and Wang, M. (2014). *China's 2008 Labor Contract Law: Implementation and implications for China's workers*. Human Relations, 68(2), pp.197-235, p. 207.
[1179] Lee, C.H. (2009). *Industrial relations and collective bargaining in China*. International Labour Office, Industrial and Employment Relations Department, Geneva: Working Paper No. 7, ILO. p. 13.
[1180] Gallagher, M., Giles, J., Park, A. and Wang, M. (2014). *China's 2008 Labor Contract Law: Implementation and implications for China's workers*. Human Relations, 68(2), pp.197-235, p. 211.
[1181] Wang, H., Appelbaum, R.P., Degiuli, F. and Lichtenstein, N. (2009). *China's New Labour Contract Law: is China moving towards increased power for workers?,* Third World Quarterly, 30:3, 485-501, p. 491.
[1182] Ibid.
[1183] Ibid., p. 493.
[1184] Labour Law, Article 79: '*After a labour dispute occurs, the parties concerned may apply to the Employers' labour dispute mediation committee for mediation; where no agreement is reached through mediation and a party requests arbitration, it may apply to the labour dispute arbitration committee for arbitration. Either party may also directly apply to the dispute arbitration committee for arbitration. Where a party is dissatisfied with the arbitration award, it may file a lawsuit to a people's court.'*
[1185] Gallagher, M., Giles, J., Park, A. and Wang, M. (2014). *China's 2008 Labor Contract Law: Implementation and implications for China's workers*. Human Relations, 68(2), pp.197-235, p. 215.

more than 100%, and civil courts labour disputes nearly doubled in 2008 compared to 2007. In 2012 there were nearly 1.6 million total formal labour disputes and 60% thereof were mediated prior to arbitration.[1186] The increase in disputes in 2008 is most probably due to the introduction of the 2008 Labour Contract Law, which gave employees more rights and stimulated the workers to seek formal enforcement of those laws.

A practical problem of labour law enforcement is the lack of resources for dispute resolution. According to official sources, in 2010 there were 600 000 arbitrated disputes and only 946 arbitration centres throughout the country. Chinese mediation and arbitration authorities handled some 1 721 000 cases in 2015, 1 771 000 disputes in 2016.[1187] Therefore an arbitration resolution can take up to two years if the procedure ends up in court.[1188] China Urban Labor Survey using a sample of 75 disputes showed that the dispute initiation rate of both local resident and migrant workers is very similar (less than 1% of workers in each group initiated a dispute, mostly about wages). Whereas the local residents were dissatisfied with the results of the dispute resolution, most migrants expressed their satisfaction, perhaps because their expectations entering into the process were lower.[1189]

13.8. FINDINGS FROM PREVIOUS TDI INVESTIGATIONS OF THE EUROPEAN COMMISSION

Previous TDI investigations by the European Commission confirmed the existence of distortions in the labour market in China. The most notable examples include lack of independence of the companies from the state, with the Chinese state intervening in the decisions of the company with regard to hiring and dismissal of staff or other staff related decisions of the company.[1190] Another distortion concerned labour contracts signed by workers in blank, without any reference to remuneration and working hours.[1191]

13.9. CHAPTER SUMMARY

According to China's Trade Union Law, Chinese workers have no possibility to freely choose or establish a trade union in which they want to organise themselves, because there is only one legally recognized trade union, the ACFTU. Furthermore, although collective bargaining of wages exists, it is not well developed.

[1186] Ibid.
[1187] See MoHRSS website: 人社部调解仲裁管理司负责人就《关于进一步加强劳动人事争议调解仲裁完善多元处理机制的意见》答记者问 http://www.mohrss.gov.cn/tjzcgls/TJZCgongzuodongtai/201704/t20170401_268936.html (accessed on 24 August 2017).
[1188] Gallagher, M., Giles, J., Park, A. and Wang, M. (2014). *China's 2008 Labor Contract Law: Implementation and implications for China's workers*. Human Relations, 68(2), pp.197-235, p. 217.
[1189] Ibid.
[1190] Sodium cyclamate L 124, 11.05.2012, p.3.
[1191] Citrus fruits, L 350, 30.12.08, p.36.

Among the eight conventions that the International Labour Association itself classifies as fundamental, China has only ratified four. China has not yet ratified the four following Conventions: No 87 (Freedom of Association and Protection of the Organise Convention), 98 (Right to Organise and Collective Bargaining Convention), 29 (Forced Labour Convention) and 105 (Abolition of Forced Labour Convention). The first two are of critical importance for the structure of the labour market in that they attribute rights to workers and employers and promote market-based wages.

The ACFTU has more than 250 million members and is present in 5 – 6 million enterprises. However, the ACFTU is not independent, but rather is closely intertwined with the Party and the State. It has its own FYP, and there is evidence that senior positions in ACFTU are occupied by senior party figures in SOEs or by managers in non-state enterprises. In other words, the union leaders appear to also be high level managers. This hampers their ability to represent workers' interests in full independence. All this can lead to situations where the management or, in the case of SOEs, the government negotiates with itself.

There is no official national-level right to strike. In fact, this right was removed from the Constitution in 1982. However in practice, strikes do happen in China and some local laws recognize some form of right to strike, but as explained in more detail above, there are also a number of reports of labour activists being arrested and detained.

Collective bargaining exists and ACFTU engages therein. In the past, the results have often been considered as insufficient by workers, but more recently some improvement has been reported. There are now a number of written laws (at provincial level and below) promoting collective bargaining, and ACFTU is also stepping up its efforts. However, the relatively vague and underdeveloped legal and procedural framework as well as the absence of a clearly recognized right to strike still constitute considerable hurdles to effective bargaining.

Finally, the Chinese workforce is impacted by the *hukou* household registration system. Only *hukou* holders have access to the full range of social security and public welfare benefits. Originally, this system restricted migration between rural and urban areas, though this restriction has been considerably relaxed. In 2014, a single national resident registration system has been introduced but there are different rules for obtaining a *hukou*, depending on the size and the area of a city, with the largest cities having more prohibitive rules. It seems to be virtually impossible for workers with the lowest qualifications (the least paid workforce) to obtain a residence permit in the large cities. Migrant workers who do not possess a local *hukou* find themselves in a vulnerable employment position in their place of residence, and according receive lower income than the *hukou* holders.

Part III

DISTORTIONS IN SELECTED SECTORS

14. STEEL SECTOR

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14.1. GOVERNMENT INTERVENTION AND INFLUENCE ON THE STEEL SECTOR IN CHINA

14.1.1. REGULATORY FRAMEWORK

The various policy documents described in this section detail the extent of intervention and control exerted by the Chinese government in the steel sector.[1192] They include the 13th FYP on Economic and Social Development (2016-20) and various implementing documents related to steel. These include in particular, the Plan for Adjusting and Upgrading the Steel Industry, as well as previous measures guiding the development of the steel industry and those addressing overcapacity problems.

[1192] This section focuses on those Plans, directives and any type of policy issued since the early 2000's, as it was the period where the Chinese steel sector started growing significantly, becoming the largest steel producer in the world.

14.1.1.1. 13th FYP on Economic and Social Development and Related Measures

The central 13th FYP, issued in March 2016, has been analysed in detail in Chapter 3. Therefore in this Chapter only the relevant provisions affecting steel are presented.

The 13th FYP sets out some general objectives with regard to the steel industry. The plan envisages an optimisation of the industrial system. To reach this objective, the 13th FYP envisages inter alia strengthening industry regulations and supervision of market access and the creation of a special fund to incentivize industrial framework restructuring. Consistent with Opinions of the State Council on Resolving Overcapacity in the Iron and Steel Industry and Achieving Turnaround in Development, issued on February 1, 2016, it also seeks to actively dissolve excess capacity. The 13th FYP provides that *'through mergers and reorganizations, debt restructuring, bankruptcy and clearance, injecting assets and creating efficiencies, we will methodically accelerate the dissolution of excess capacity in industries such as coal or steel.*'[1193]

The plan also provides for different measures related to environmental protection that affect the steel sector e.g. outlawing heavily polluted projects that would fail to meet the standards set by the national industrial policies. Similarly, the 13th FYP commits to effectively control the carbon emissions in industries like steel.

14.1.1.2. Steel Industry Adjustment and Upgrading plan

In November 2016, shortly after issuance of the 13th FYP, the 'Steel Industry Adjustment and Upgrading plan for 2016-2020' (the '13th FYP for Steel' or 'the Plan')[1194] was released by MIIT. This Plan states that the steel industry is '*an important, fundamental sector of the Chinese economy, a national cornerstone*'.[1195] Therefore, as was the case under the 12th FYP and its predecessors, steel continues to be a favoured sector in the Chinese economy. The 13th FYP for Steel also stresses the pivotal role of the enterprises as well as the support by governmental and local authorities. In particular, the 13th FYP for Steel focuses on structural changes to be made on the supply-side in order to address the problem of overcapacity.[1196]

The main tasks and objectives set out in the 13th FYP for Steel cover virtually all aspects of the development of the industry, thus showing the high degree of intervention exerted by the government over the sector. They are outlined below:

[1193] 13th FYP, Section 2.5.1 (5).
[1194] The full text of the plan is available on the MIIT website: http://www.miit.gov.cn/n1146295/n1652858/n1652930/n3757016/c5353943/content.html; (accessed on 7 July 2017).
[1195] Introduction to The Plan for Adjusting and Upgrading the Steel Industry.
[1196] The introduction of the Plan acknowledges overcapacity as one of the problems in the Chinese steel sector.

Production capacity reduction

The 13th FYP for Steel sets out, as one of its main objectives, the reduction of the overcapacity in the sector. The Plan targets a reduction of 100-150 million metric tonnes ('mmt') of crude steel by the year 2020.[1197]

To this end, it envisages the closure of production capacity which does not meet the standards on environmental protection, energy consumption, quality, safety, technologies and production policies. The 13th FYP for Steel includes specific criteria with regard to the overall shutdown and dismantling by 2016, with a few exceptions, of blast furnaces of 400 m^3 and less, steel converter furnaces of 30 tonnes and less, electric furnaces of 30 tonnes and less and other obsolete production equipment. The 13th FYP for Steel also prohibits any investment related to building and expanding steel production of a certain size, and prohibits any increase in steel smelting capacities.[1198]

Specific measures include active reductions, mergers and reorganisations, model changes and production transfers. The 13th FYP for Steel also indicates that specific subsidy funds and other incentives shall be used to encourage regions with large production to actively reduce steel production capacity.

In order to effectively deal with the consequences of a reduction in capacity, the Plan sets out ways to lessen its effects on the sector, most notably the relocation of redundant workforce, the use of subsidies for programs focused on structural adjustment of industry and enterprises, and provision of subsidies at the local level.

In addition, the 13th FYP for Steel recognises that the survival of *zombie* companies, (i.e. companies which, despite not being economically viable and with no prospects of becoming profitable, continue to operate) is exclusively due to continuous lending by the banks and other types of support usually by local authorities.[1199] The 13th FYP for Steel provides that *zombie* companies shall effectively disappear from the market. Once identified, these companies shall not have access to financial subsidies and bank loans anymore.[1200]

Upgrading and ensuring effective supply of steel product types

The 13th FYP for Steel recognised the achievements made in by the 12th FYP for Steel, for instance, as regards key medium- and-large sized steel enterprises. The Plan highlighted that the production of high-strength steel bars of 400 Mpa (grade III) and above accounted for 99,6%, thereby reaching the 12th FYP "above 80%" objective. The Plan acknowledged that

[1197] Table 2 of the Plan lists a number of measures aimed at effectively implementing the goal of reducing overcapacity.
[1198] Steel Industry Adjustment and Upgrading Plan, Section III-3.
[1199] See also the definition provided at: Lam, W. R., Schipke, A., Tan, Y. and Tan, Z. (2017). IMF Working Paper: 'Resolving China's Zombies: Tackling Debt and Raising Productivity'; WP/17/266, p.6.
[1200] Steel Industry Adjustment and Upgrading Plan, Section IV.

steel quality has improved significantly and that China has produced 497 types of steel products attaining foreign advanced quality level in 40% of the products.[1201]

The 13th FYP for Steel envisages support to enterprises focusing on shipbuilding, aviation/aerospace, machinery, electrical power and others requiring research and industrialization of high-end steel product types. The objective is to achieve by 2020 the effective supply of key steel product types. In this regard, the Plan specifically sets out that every year a breakthrough for 3-4 key-product types shall be ensured, so as to keep on raising efficient supplies. The Plan contains a detailed list of such high-end steel products and the sectors where they are to be used:[1202]

Marine engineering and shipbuilding: high energy input welding steel, high resistance thick panels, corrosion resistant high-manganese steel, steel used for offshore platform pillar structures;

Railway equipment: steel for high speed train wheels, weathering and corrosion steel for train wagons, high-strength steel tracks;

Energy saving and new energy vehicles: ultra-high strength automotive steel, hot-stamped coated steel, steel for ultra-high strength shielded cables;

Electrical power equipment: heat resistant steel for thermal power stations, steel for forgings and blades of steam turbines and electricity generators, steel for internal components of pressurised water reactors in nuclear power plants;

Key basic spare parts: high-strength steel for high-performance bearings, gears, springs, transmissions used in advanced manufacturing industry, high-strength and high-durability unquenched and untampered steel, steel of 12.9 grade and above for high-strength fasteners.

Other high quality special steel: high quality cold heading steel, special steel for machinery ball screws, free cutting tool steel for complex cutting tools, ultra-high-strength stainless steel used in special equipment, corrosion resistant steel used in energy saving and environmental protection and chemical industry equipment, low-loss and special purpose silicon steel, large cross-section, high-performance steel used for cold-rolling rolls, high-temperature alloys, rolled composite panels.

Industry re-organisation and restructuring

The 13th FYP for Steel pushes reorganisation within the steel sector by promoting mergers and restructuring. It aims ultimately at setting up fewer, but larger, steel enterprises (*'national champions'*), inter alia, to avoid 'competitive vicious circle' on certain products. The 13th FYP for Steel specifies that the ten largest enterprises in the sector shall constitute 60% of

[1201] Ibid., Section I.
[1202] Ibid., Section IV.

total production. This means an increase of more than 25% with respect to the end of the 12th FYP.[1203]

Financial policies

The 13th FYP for Steel gives guidance to financial institutions and private capital to support the priority tasks of the Plan. With regard to iron ore mines, the Plan promotes the alleviation of taxes and fee burdens applicable to them. The implementation of the Plan's targets is to be carried out through the use of the '*driving force of subsidy funds for programmes dedicated to the structural adjustment of industry and enterprises*'. Also, the Plan envisages handling companies' debt and financial institutions' bad assets via '*market tools*'.

Furthermore, the 13th FYP for Steel provides for improvement of fiscal, tax and financial policies by fully using existing funding channels, encouraging local authorities to explore various types of support measures, and giving guidance to financial institutions and private capital to support the priority tasks of the 13th FYP for Steel.[1204]

Quantitative targets

The 13th FYP for Steel includes a number of quantitative targets, including improving the capacity utilisation rate from 70% (2015), to 80% by 2020, reducing the crude steel production capacity by 100-150 million tonnes, setting up eight new smart steel manufacturing demonstration experimental projects, as well as other targets.[1205]

Besides the goals of reducing overcapacity and restructuring of the industry through mergers and acquisitions, other objectives outlined in the 13th FYP for Steel include:

Geographic location of steel factories

The Plan outlines the main targets regarding the location of production facilities in different regions. The 13th FYP for Steel provides that no new coastal factories will be set up. Rather, it encourages developing the already existing production sites in coastal areas in line with the Plan's objectives (i.e. reduction of capacity, integration, efficiency).

With regard to the objectives for particular regions, the Plan envisages:[1206]

Beijing, Tianjin, Hebei and the surrounding regions, Yangzi River Delta:

- To alleviate the pressure on the regions' environment; to reduce production volume through reorganisation; to examine the complete withdrawal or conversion of urban steel factories.

[1203] Ibid., Section III, Table 1. This target is a repetition from the 12th FYP for Steel, which also aimed at 60% industrial concentration in steel, however in fact it fell from 49% in 2010 to 34% in 2015. Source: http://www.miit.gov.cn/n1146295/n1652858/n1653018/c5355576/content.html (Last accessed on July 2017).
[1204] Ibid., Section V-2.
[1205] Ibid., Section III-3.
[1206] Ibid., Section IV-2.

Central and western regions and north-east old industrial bases:

- To reduce the number of companies; to reduce overcapacity; to implement regional coordination.

East-southern coastal regions:

- To change the sector's current layout of '*heavy industry in the North, light industry in the South'*; to establish first-class coastal producers in Zhanjiang and Fangchenggang.

Factories located in urban areas:

- To ensure the balance between, inter alia, urban planning, environmental requirements, land resources, tax revenue ratios; to proceed to production transfer and relocation.
- For those factories failing to meet the urban development requirements and/or having weak competitiveness, the Plan requires that they should withdraw from the market unless they can comply with the necessary requirements.

Securing iron ore resources abroad

The 13th FYP for Steel aims at security of supply of iron ore. It stipulates the creation of an iron ore market mechanism: '*Foster the emergence of an iron ore market mechanism objectively reflecting the supply and demand relationship and meeting the interests of all stakeholders.'* Furthermore, the Plan indicates that eligible enterprises will be supported in using their own capital or in forming joint ventures to: (i) set up top-quality and low-cost mineral resource production bases abroad; and (ii) carry out equity investments in overseas mining resources.

In addition, the 13th FYP for Steel envisages supporting exploration works in key domestic mineral areas. It also calls for support for a number of existing and highly competitive domestic iron ore enterprises in order to strengthen the role of domestic mineral resource bases as regards security of supply (the plan does not specify the type of support offered to those enterprises).[1207]

Reduce the enterprises' asset/debt ratio

For those companies with a high ratio, the 13th FYP for Steel states they must reduce their debt; that inefficient economic projects or with a capital ratio below 40% shall be stopped and that companies with assets insufficient to reduce their debt shall proceed to bankruptcy, reorganization, debt restructuring or liquidation.[1208]

[1207] Ibid., Section IV-9.
[1208] Ibid., Section IV-1.

Increase innovation capacities

The 13th FYP for Steel provides that the focus should be placed, inter alia on: low energy consumption smelting technologies; highly energy-efficient rolling technologies; setting up innovation platforms at a national level; integration of scientific and technological resources.[1209]

Improve the level of quality of steel products

The 13th FYP for Steel focuses on achieving product quality, durability and reliability; it also calls for a more automatized system of quality control (reducing the influence of the human factor), and for supporting companies using technologies related to clean steel production, precision rolling and quality improvement. In addition, it envisages the publication, on a yearly basis, of the list of quality products and quality brand products having reached the physical quality level of international similar products, so as to expand efforts to foster brands.[1210]

Foster smart and green manufacturing

The 13th FYP for Steel aims at achieving a steel production system whereby energy-saving and emission-reducing technologies are widely used.[1211]

Implementation mechanism

Lastly, the 13th FYP for Steel specifically shows that the management of the steel sector shall be organised by the administration in charge of the (steel) industry on the basis of the present plan, strengthening its supervision. It calls for local authorities and administrations to coordinate their adjustment and upgrading efforts in line with the 13th FYP for Steel, and to implement the tasks and policy measures included in it. It ultimately calls for the relevant companies to ensure that they adhere to the Plan's main objectives and tasks; and for China Iron and Steel Association ('CISA') to identify potential issues arising from the implementation of the 13th FYP for Steel and formulate policy suggestions accordingly.[1212]

Implementation at the Provincial Level

The roll-out of the 13th FYP at the provincial level is implemented by provincial plans. For example, below are some excerpts related to the steel industry found in the local plan of one of China's largest steel producing regions, Hebei Province:

> [Hebei shall] *support leading enterprises in industries such as steel, equipment, construction materials* […] *to proceed to asset restructurings, resource integration*

[1209] Ibid., Section IV-3.
[1210] Ibid., Section IV-5.
[1211] Ibid., Section IV-5 and IV-6.
[1212] Ibid., Section V-4.

and entry of strategic investors in order to effectively implement strong alliances, pool innovation resources, raise innovation level, and develop so as to become leading innovative enterprises with international competitiveness.[1213]

Specific 'metallurgy projects' are included in a list of '*Main projects for reform, relocation and upgrade of traditional industries having a competitive advantage*'[1214] while '[Hebei shall] *contain production capacities for steel, cement and glass at respectively 200 million tonnes, 200 million tonnes and 200 million weight cases approximately*'.[1215]

Some examples of projects in the plan include:

- Setting up a quality steel base in Caofeidian district as a reliable alliance for industrial innovation in the field of steel;
- Tangshan Bohai Iron and Steel Ltd: joint reorganisation, relocation and transformation of urban steel factories;
- Handan (city) Iron and Steel Group: assembly steel structures and green construction industrial engineering

As an example of how the steel policy is translated into practice at the municipal level, the municipal plan of Tangshan is illustrative: The city of Tangshan in Hebei province will continue to promote transformation and restructuring of the steel industry in 2017, aiming at building up two mega groups (Shougang Group and HBIS Group Tangsteel Company) and two large enterprises (Bohai Steel and Great Wall Steel). Supportive measures include:

- Pushing forward 'de-capacity' by implementing differentiated electricity and water prices and allocating RMB 100 million as an award fund;
- Facilitating reorganisation of steel makers by equity investment and subsidised loans and encouraging eligible enterprises to carry out cross-area, cross-sector and cross-ownership mergers and reorganisation;
- Encouraging enterprises to be involved in major construction projects in countries along the Belt and Road Initiative and set up overseas manufacturing bases;
- Using events like the 3rd Local Leaders' Meeting of China-CEEC and the 10th China-Lac Business Summit to enhance international capacity cooperation; allocating an economic development fund of RMB 20 million every year to boost international capacity cooperation;

[1213] Hebei Province 13th FYP for 2016-2020, Section II-3.
[1214] Ibid., Section III-6.
[1215] Ibid.

- Setting up commerce liaison offices in Japan and the US to help Tangshan enterprises to participate in events overseas and go global;
- Setting up an export credit insurance fund for exporters in Tangshan.[1216]

Upgrading product types

The Tangshan plan, in line with the objectives set out by the 13th FYP for Steel, also focuses on the development and upgrading of steel product types. To this end, the plan seeks to improve technological innovation as well as research and development. In particular, the plan highlights the objective of strengthening quality strip and wire rod. As a result, the plan envisages that by 2020, the proportion of high value-added products will be 30%, and production bases for high-strength automotive sheet and high-strength steel will be created.

14.1.1.3. EARLIER MEASURES GUIDING THE STEEL INDUSTRY IN CHINA

During the previous decade, a series of measures were undertaken with the goal of fostering the development of the Chinese steel industry, as well as addressing overcapacity problems in the industry that arose, at least, as early as 2003 (*see*, e.g. 'Several Opinions on Restricting Blind Investment in the Iron and Steel Industry', issued by NDRC, MOFCOM, the Ministry of Land and Resources, the Ministry of Environmental Protection, and the CBRC on November 19, 2003).

For example, the 'Development Polices for the Iron and Steel Industry' ('Order 35' or 'National Steel Policy'), promulgated on 8 July 2005 by the NDRC upon the authorisation of the State Council, illustrates the types of intervention mechanisms utilized in China over the past decade.

Article 7 states:

> *The state shall guide the iron and steel industry to develop in a sound, sustainable and harmonious manner through the development policies and the mid- and long-term development planning of the iron and steel industry. The mid- and long-term development planning of the iron and steel industry shall be formulated by the National Development and Reform Commission in collaboration with other relevant departments.*

The measure envisages a decrease in the number of iron and steel smelting enterprises and sets goals for the output of those steel enterprise groups that rank in the top 10 in the domestic market (Article 3), prohibits the establishment of new iron and steel complexes (Article 10), sets rules for changes in the organisational structure of steel enterprises (Article 20), manages investments (Article 22, 23), sets conditions for access to financial funds (Article 25,26), and gives the State the right to intervene in the purchase of raw materials (Article 30).

[1216] See Ibid., as well as the Tangshan 13th FYP for 2016-2020.

Another illustrative document, the 'Blueprint for the Steel Industry Adjustment and Revitalisation', issued in 2009 and intended to cover the period from 2009-2011, was released during the international financial crisis with the objective of stabilising the Chinese steel sector. The document clearly spelled out that the recommendations of the 17th Congress of the CCP should be comprehensively implemented.

Situation of the Chinese steel sector

The blueprint began by acknowledging that the *'overexpansion of aggregate capacity'* as a result of *'blind investments'*, had become *'more troublesome than ever'*. It estimated the existing overcapacity in 2008 to be around 100 mmt. It also pointed at the poor geographical location of production capacities, mainly located in or nearby large and middle-sized inland cities, which created restrictions in terms of environmental absorbing capacity, water resources, transportation and energy supplies. In addition, the document pointed at a low concentration rate, noting that the average production capacity was below 1 mmt, with the top 5 producers accounting for less than 30% of the total domestic production.

The document also acknowledged that demand, production and prices were falling sharply as a result of the financial crisis, and that all producers were loss-making. The document went on to highlight the need for a substantial adjustment in the sector. [1217]

Strategic role of steel sector

The document regarded the steel industry as a mainstay industry for the national economy, playing a crucial role in social development, finance and taxation, national defence construction and employment stability.

Quantitative Targets

Amongst the targets to be reached, the document set goals to:[1218]

- Reduce the production levels to 460 mmt, representing a reduction of 8% when compared to the year 2008;
- Not approve new steel facilities and projects (or the expansion thereof), except to reach the goal of eliminating backward capacity or comply with the overarching objective of dismantling production capacity. In figures, by 2010 the document envisages dismantling 53.4 mmt of capacity of blast furnace of 300m³ or less, and 3.2 mmt of converter and electric furnace of 20 tonnes or less. The targets for 2011 include elimination of 25 mmt capacity of steel smelting capacity and of 72 mmt of iron making capacity;

[1217] Blueprint for the Steel Industry Adjustment and Revitalisation, Section I.
[1218] Ibid., Section II-C.

- Achieve significant progress in the reorganisation and integration of companies within the sector. The top 5 producers should account for 45% of total production, and production in coastal areas should account for 40% or more of total production. Production in urban areas should be substantially reduced;

- Increase the concentration ratio and reorganisation within the industry, aiming at developing fewer but stronger super large steel companies like Baosteel, Anben Group and WISCO (with production capacity of around 50 mmt), and several groups with production capacity between 10-30 mmt;

Financial policies

The document aimed at ensuring financial support for key enterprises in the steel industry. As regards decision-making on the issuance of publicly traded shares, bonds, bank notes, and bank credit and using private equity investment, certain companies were prioritised. In addition, the document foresaw that interest grants should be provided to large enterprises using commercial credit loans when necessary to prevent severe breakdown in cash flows.[1219]

Reorganisation of the industry

The document underlined the leading role of large groups like Baosteel, Anben and WISCO. It also specifically addressed changes to be carried out at company-specific level, i.e.: promote internal reconstruction within several groups (Anben Group, Guangxi Group, Hebei, Shandong); promote the inter-regional reconstruction of Anben and Panzhihua Steel and Dongbei Special Steel, Baosteel and Baogang and Ningbo Steel, etc.; and promote regional reconstruction such as for TISCO and other steel companies within the province. To this end, the document sought to facilitate mergers, acquisitions and reorganisation of steel mills. [1220]

The document envisaged, inter alia: [1221]

- the creation of a coastal base of steel production facilities;

- completion of the Shougang relocation; the Caofeidian Steel quality base;

- the construction of Zhanjiang, Fangcheng port coastal steel quality base;

- the relocation of Jigang, Laigang, and Qingdao Steel;

- promotion of the construction of Rizhao Steel quality base; consider the trans-regional restructuring and elimination of the backwardness of Baosteel and the relocation of Hangzhou Steel to validate the continued construction of Ningbo Steel;

[1219] Ibid., Section IV-9.
[1220] Ibid., Section III-3.
[1221] Ibid., Section III-5.

Securing iron ore resources

With a view to ensuring the domestic supply of iron ore, the document called for[1222]:

- Promoting the exploitation of large-sized iron ore mines in Sijiaying, Yuanjiacun, and increasing the degree of self-sufficiency of iron ore;
- Supporting the deep exploitation of ore in Handan Zhongguan, Tang Steel Shirengou, Tonhg Steel Tadong, and Wu Steel Enshi;
- Encouraging comprehensive resource use of vanadium and titanium in Panxi, Chengde;
- Carrying out integrated development of iron ore resources in Huoqiu and Cangshan.

Export policy

With regard to export policy, the plan contained the following provisions:[1223]

- Improving the import and export of steel products by implementing an appropriate export tax policy, stabilising market share in international markets;
- Continuing the policy orientation of controlling exports of low value-added goods;
- Raising the rates of VAT refund for steel products with high technical content and high value-added.

Local implementation

The document states that local governments should actively formulate their own blueprint to meet the targets, achievements and policy options of the document. It also encouraged local departments to communicate with the NDRC in the course of the implementation phase.[1224]

The State Council was tasked with follow up through guidance, evaluation and supervision roles.

In March 2015, the Steel Industry Adjustment Policy was issued by the MIIT for public comment. It was intended to replace Order No. 35 of the NDRC, discussed above. However, no final version was formally issued.

[1222] Ibid., Section III-7.
[1223] Ibid., Section IV-1.
[1224] Ibid., Section V.

Examples of other relevant documents include:

- Opinions of the General Office of the State Council on Making Further Efforts in Energy Conservation and Emission Reduction and Accelerating the Structural Adjustment of the Iron and Steel Industry (2010)
- Guiding Opinion of the State Council Regarding Resolving the Contradiction of Serious Overcapacity (2013)

  This opinion, issued by the State Council, recognised the problem of overcapacity and attributed it to several government policies. The opinion focused primarily on how to address the problem of overcapacity.[1225]
- Guiding Opinions on Pushing Forward Enterprise Mergers and Acquisitions and Reorganization in Key Industries (2013)[1226]

14.1.2. SOEs PRESENCE IN THE STEEL MARKET

The role and features of SOEs have been described in Chapter 5. In the case of steel, SOEs play a central role. Currently, the split between SOEs and privately owned companies is estimated to be almost even in the Chinese steel sector (51% private and 49% SOEs for production, and 44% SOEs and 56% private companies for capacity).[1227] Five Chinese steel producers (four of which are SOEs) are ranked in the top 10 of the world's largest steel producers.[1228] This shows that the Chinese steel market is characterized by the significant presence of large SOEs. In addition, there is also a significant presence of SOEs in the mining industry, which sources some key raw materials for steel production.[1229] For example, large steelmaking SOEs like Anshan Iron & Steel Corporation, Panzhihua Iron & Steel Corporation and Benxi Steel, also own iron ore mines.[1230]

As concluded in Chapter 5, SOEs are used as vehicles to pursue the government's economic policies. This is also the case in the steel industry and was confirmed in several trade defence

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[1225] Guiding Opinion of the State Council Regarding Resolving the Contradiction of Serious Overcapacity Guo Fa [2013] No. 41. 国务院关于化解产能严重过剩矛盾的指导意见 国发〔2013〕41 号, available at http://www.gov.cn/zwgk/2013-10/15/content_2507143.htm

[1226] 关于加快推进重点行业企业兼并重组的指导意见 工信部联产业〔2013〕16,号, No. 16 [2013] of the MIIT.

[1227] See the official website of CISA: http://www.chinaisa.org.cn/gxportal/DispatchAction.do?efFormEname=ECTM40&key=CmkINwhjVzZQMQQzXzgNbFczAWEDZwYzUmMFN1QxADxURwFOW0BZaVRFA0QHEAJg This figure may nonetheless be understated because it does not include any joint venture of SOEs.

[1228] World Steel Association. (2016). *Top steel-producing companies* https://www.worldsteel.org/steel-by-topic/statistics/top-producers.html (The four SOEs are: China Baowu Group, HBIS Group, Ansteel Group and Shougang Group). The combined production of these four companies amounted to around 170 mmt in 2016. For a full list of producers above 3 mmt (2016), see World Steel Association. (2016). *Top steelmakers in 2016*: https://www.worldsteel.org/en/dam/jcr:b8a5256f-6b2f-40ae-80cc-f25c029b48eb/Top+50+steelmakers+2016_web.pdf (documents accessed in July 2017).

[1229] OECD. (2012). *Steelmaking Raw Materials: Market and Policy Developments*.

[1230] See top 10 list at: OECD. (2012). *Steelmaking Raw Materials: Market and Policy Developments*, table 12.

investigations by the European Commission which established, inter alia, the following: the government exercises meaningful control over steel SOEs, which are obliged to follow the governmental plans and policies;[1231] SOEs exercise government authority;[1232] the main objective of steel SOEs is to reach the targets and objectives set by the government's plans.[1233] SOEs are the primary target of state policies aiming at restructuring and consolidating the steel sector by creating fewer but larger steelmakers.[1234]

Some recent examples of how these policies are being implemented include, on the one hand, the reportedly economically nonviable recent merger between Baosteel and Wuhan Steel, which gave rise to the second largest steel producer of the world,[1235] Baowu Steel,[1236] and on the other hand, the refusal for a merger between Shougang Corporation and Hesteel Group Co., Ltd, allegedly prohibited on the basis that there was 'neither an agenda nor a directive for that in the State Council document.'[1237]

With the high level of government intervention in the steel industry and a high share of SOEs in the sector, even privately owned steel producers are prevented from operating under market conditions. In this regard, the European Commission found, in the anti-subsidy investigation on *Organic Coated Steel from China*[1238] inter alia, that:

> *The SOEs are predominant in the HRS market in China. This predominance of SOEs in the HRS market is so considerable that the private producers have no choice but to align their prices with the SOEs.* [1239]
>
> *The investigation at the exporters of OCS established that the prices paid by the four exporting producers/groups during the IP for the HRS and CRS sourced from private producers of HRS and CRS or from traders were consistently very close to the prices of SOEs. Thus the observed data, together with the predominance of SOEs in this sector, demonstrates that the price of private suppliers effectively*

[1231] Council Implementing Regulation (EU) No 215/2013 of 11 March 2013 imposing a countervailing duty on imports of certain organic coated steel products originating in the People's Republic of China para. 72.
[1232] Ibid.
[1233] Ibid., para 68.
[1234] In particular: Guiding Opinions on Pushing Forward Enterprise Mergers and Acquisitions and Reorganization in Key Industries (2013); Steel Industry Adjustment Policy (2015 Revision) and The Plan for Adjusting and Upgrading the Steel Industry (2016-2020).
[1235] World Steel Association. (2016). *Top steel-producing companies*. https://www.worldsteel.org/steel-by-topic/statistics/top-producers.html (Last accessed on 12 July 2017)
[1236] See Baowu website: *Baosteel Co., Ltd. Consolidated by Merger with WISCO，Crude Steel Production Volume after Consolidation was Ranked Top 3 among Global Listed Steel Enterprises* http://www.baowugroup.com/en/contents/5319/104013.html (Last accessed on 12 July 2017)
[1237] Bloomberg. Company Overview of Shougang Group Co., Ltd http://www.bloomberg.com/research/stocks/private/snapshot.asp?privcapid=5471051 (Last accessed on 12 July 2017)
[1238] Council Implementing Regulation (EU) No 215/2013 of 11 March 2013 imposing a countervailing duty on imports of certain organic coated steel products originating in the People's Republic of China, OJ L 73, 15.3.2013, p.16.
[1239] Ibid., para. 77

tracks the prices paid to SOEs. Furthermore, in the contract submitted by one of the sampled exporting producers for the provision of HRS by a privately owned supplier there is even a condition to link the price to the SOE supplier price.[1240]

The government export restriction, government planning and the predominance of SOEs limits the freedom of private suppliers of HRS and CRS, obliging them to act in a non-commercial manner and to accept economically irrational (below-market) prices which they would not do in a free and open market. This confirms that the government policy to supply HRS and CRS (including to the organic coated steel sector) extends to private suppliers. [1241]

The following statement by the country's largest private steel producer, Jiangsu Shagang, also serves as an illustrative example of how even private companies adhere to the policies from the government:

In the future, Shagang Group will conscientiously implement the State policy concerning the steel industry development. With the guideline of the Scientific Concept of Development, Shagang would persistently follow the development strategy of "Doing the Steel Industry Finer and Stronger, Doing the Modern Logistics Stronger and More Excellent, Doing the Non-Steel Industry better and more sufficient". Shagang shall continuously speed up its pace of the transformation and upgrading, and constantly enhance its comprehensive competitiveness. Shagang Group will make new contributions in order to forge a "Hundred-year Old Factory", construct a harmonious Jiangsu and build a powerful steel country.[1242]

In the same vein, a study also pointed at substantial ownership, control and/or government intervention with respect to the allegedly privately-owned steel companies. [1243]

14.1.3. FINANCIAL SYSTEM IN CHINA – IMPACT ON THE STEEL SECTOR

Chapter 6 has described, in detail, the functioning of the banking and financial sector in China. Therefore, for the purpose of this chapter only the sector's most relevant features concerning steel industry are highlighted.[1244]

[1240] Ibid., para. 80
[1241] Ibid., para. 97.
[1242] See Shagang Group website http://www.sha-steel.com/eng/ (Last accessed on 10 July 2017)
[1243] Price, A.H., Brightbill, T.C., Weld, C.B. and Nance, D.S. (2007). *Government ownership and control of China's "private" steel producers:* https://www.lexology.com/library/detail.aspx?g=806b748a-5820-4607-9ffe-fb3ab9adb09f (document last accessed on 12 July 2017)
[1244] For a detailed analysis on the Chinese financial sector and its impact on the steel sector, see Commission Implementing Regulation (EU) 2017/969 of 8 June 2017 imposing definitive countervailing duties on imports of certain hot-rolled flat products of iron, non-alloy or other alloy steel originating in the People's Republic of China and amending Commission Implementing Regulation (EU) 2017/649 imposing a definitive anti-dumping

The European Commission found in the anti-subsidy investigation into *Hot-Rolled Flat products* from China ('HRF')[1245] that '*The Guidelines of the People's Bank of China, CBRC, CSRC, and CIRC*', as well as the notice '*Several Opinions on Resolving Overcapacity*', are specifically targeted at companies in the steel sector:

> *financial institutions must fully recognize the pillar role and strategic importance of steel and coal industries and continue to give credit support to the steel companies which comply with industrial policy and which adjust and regroup themselves without increasing their production capacity. This support shall extend to the setting of interest rates and the promotion of bonds and loans for mergers and acquisitions. Furthermore, debt restructuring and debt forgiveness is promoted.*[1246]

The European Commission concluded that State-owned financial institutions, in implementing the relevant regulatory framework in China, exercise governmental functions with respect to the steel sector and therefore act as public bodies within the meaning of the basic Regulation and in accordance with the relevant WTO case-law.[1247]

In addition, the Commission found that '*in so far as the steel industry is concerned, all financial institutions (including private financial institutions) operating in China under the supervision of the CBRC have been entrusted or directed by the State to pursue governmental policies and provide loans at preferential rates to the steel industry*'.[1248]

Overall, in the investigation concerning HRF from China, the European Commission concluded that '*the government has exercised meaningful control over the conduct of the five cooperating state-owned banks with respect to their lending policies and assessment of risk, where they provided loans to the steel industry*'.[1249]

The control of the government over banks has a direct influence on the manner in which loans, credits and access to finance in general, is provided to steel producers. It is therefore the government's control over the financial sector that, inter alia, has created the so-called 'zombie companies' and therefore, played a major role in the severe overcapacity problem to which China is the main contributor (see Section 14.4).

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duty on imports of certain hot-rolled flat products of iron, non-alloy or other alloy steel originating in the People's Republic of China; OJ L 146, 9.6.2017, p.17rec. 83-244, and OCS 160-195.

[1245] Commission Implementing Regulation (EU) 2017/969 of 8 June 2017 imposing definitive countervailing duties on imports of certain hot-rolled flat products of iron, non-alloy or other alloy steel originating in the People's Republic of China and amending Commission Implementing Regulation (EU) 2017/649 imposing a definitive anti-dumping duty on imports of certain hot-rolled flat products of iron, non-alloy or other alloy steel originating in the People's Republic of China; OJ L 146, 9.6.2017, p.17.

[1246] Ibid., para. 113.

[1247] Ibid., paras 129 and 139: '*the investigation found that all 35 state-owned Chinese financial institutions that provided loans to the four sampled groups of cooperating exporting producers are public bodies'*.

[1248] Ibid., para. 146.

[1249] Ibid., para. 128.

The above findings from the European Commission's investigation clearly show that the financial sector in China is directed by the government. The Chinese financial institutions have, as their main purpose, the implementation of public policy objectives,[1250] and therefore their functioning is not fundamentally guided by market principles. Several investigations have also demonstrated that Chinese steel producers benefit from State support measures from these institutions, inter alia, by access to finance at non-commercial terms (see Section 14.2).[1251]

14.2. STATE SUPPORT MEASURES

The Government of China has consistently used a wide array of State support measures to promote the steel industry, and hence, implementing the industrial policy objectives described in section 14.1.1. These measures have a distortive effect on the market as they grant an artificial advantage to the recipients, *vis-à-vis* those competitors who do not benefit from the measures, thereby contributing to an uneven playing field.

The European Commission, as well as other investigating authorities, has consistently found evidence of these measures, as described below:

The Commission has recently established that the Government of China provided numerous forms of state support, some of which were found to be of a permanent and structural nature in the steel sector. In *Hot-rolled flat products from China,* it was established that:

> *Most of them* [support schemes investigated] *are permanent by nature, such as land use rights, tax breaks and grant programmes. Moreover, the credits received were a constant feature of Chinese industrial policy to support its steel industry. The Commission concluded that these subsidies were of structural nature.*[1252]

More specifically, several Commission anti-subsidy investigations [1253] determined that numerous subsidy schemes, within the following main categories, have been provided to Chinese steel producers:[1254]

[1250] Article 34 of the Law of the People's Republic of China on Commercial Banks (2003), exemplifies this situation: '*Commercial banks shall conduct their business of lending in accordance with the needs of the national economic and social development and under the guidance of the industrial policies of the State'.*

[1251] See Section 2.4 for specific examples.

[1252] Commission Implementing Regulation (EU) 2017/969 of 8 June 2017 imposing definitive countervailing duties on imports of certain hot-rolled flat products of iron, non-alloy or other alloy steel originating in the People's Republic of China and amending Commission Implementing Regulation (EU) 2017/649 imposing a definitive anti-dumping duty on imports of certain hot-rolled flat products of iron, non-alloy or other alloy steel originating in the People's Republic of China; OJ L 146, 9.6.2017, para. 476.

[1253] Ibid. and Council Implementing Regulation (EU) No 214/2013 of 11 March 2013 imposing a definitive anti-dumping duty and collecting definitively the provisional duty imposed on imports of certain organic coated steel products originating in the People's Republic of China.

[1254] A complete list of all subsidy schemes found countervailable in each of the investigations referred to in this section, is available in the relevant texts cited.

- Preferential policy loans, credit lines, preferential interest rates, other financing, and guarantees;
- Grant Programmes;
- Direct Tax Exemption and Reduction programmes;
- Indirect Tax and Import Tariff Programmes;
- Government provision of goods and services for less than adequate remuneration ('LTAR'), including: inputs, land use rights, water and electricity;
- Equity programs, including: debt for equity swaps, equity infusions and unpaid dividends

Other investigating authorities have also found that Chinese steel producers have consistently received numerous subsidies:

In *Hot Rolled Plate Steel from China,*[1255] the Australian investigating authority determined that countervailable subsidies within the following categories had been provided to Chinese producers:

- Provision of steel inputs at LTAR:
- Provision of raw materials (coking coal, coke)
- Preferential Tax Policies
- Tariff and VAT exemptions on imported materials and equipment
- Grants (including for elimination of out dated capacity)
- Others

In 2016 the Australian investigating authority, in *Grinding Balls from China,*[1256] determined that subsidy schemes within the following categories were countervailable:

- Preferential loans and interest rates
- Income Tax
- Grants
- Tariff and VAT exemptions on imported materials and equipment

In Canada's most recent investigation on steel, *Fabricated Industrial Steel Components from China,*[1257] the CBSA deemed that countervailable subsidies within the listed categories had been granted to steel producers:

[1255] Australian Anti-Dumping Commission: *Dumping of Hot Rolled Plate Steel Exported from the People's Republic of China, Republic of Indonesia, Japan, The Republic of Korea and Taiwan and Subsidisation of Hot Rolled Plate Steel Exported from The People's Republic of China*, Report Number 198; (2013), pp. 41-43.
[1256] Australian Anti-Dumping Commission; *Alleged Dumping and Subsidisation of Grinding Balls Exported from The People's Republic of China*, Report 316; June 2016.
[1257] CBSA, *Statement of Reasons concerning the final determinations with respect to the dumping and subsidisation of certain fabricated industrial steel components from, inter alia, the People's Republic of China*; 10 May 2017.

- Special Economic Zones (SEZ) and other Designated Areas Incentives
- Award for Tax Payments
- Preferential Loans and Loan Guarantees (including preferential loans from State-owned banks)
- Grants and Grant-equivalents
- Preferential Tax Programs
- Relief from Duties and Taxes on Inputs, Materials and Machinery
- Goods/Services Provided by the Government at Less than Fair Market Value

The CBSA had also previously established that subsidies had been provided to steel producers, inter alia, in *Steel Piling Pipe from China*[1258] and *Concrete Reinforcing Bar from China.*[1259]

The investigations cited above are not an exhaustive list, as there are other investigating authorities that have also found the existence of countervailable subsidies from the Chinese government on steel products.[1260]

The findings of the different investigating authorities in the selected cases listed above confirm the presence of a wide range of State support measures in the Chinese steel sector. This is therefore a clear illustrative example of how the Chinese government actively implements the policy and industrial objectives set out in the Plans for the steel sector. Through the provision of State support measures, Chinese steel producers achieve significant reductions in their costs of production for some key elements, e.g. steel inputs, raw materials, land use rights, electricity and water. In this respect, it is noted that steel production is energy intensive and therefore energy is a key input for steel producers. Consequently, Chinese government intervention in the energy sector has led to market distortions (see Chapter 10), impacting on the cost and prices of steel products. The provision of State support measures also has an impact on the financial situation of the companies. For instance, through preferential lending, debt for equity swaps, or debts cancellations, the viability of companies, which would otherwise have been forced to file for bankruptcy under commercial considerations, is ensured.[1261] The presence of some of these State support measures has been found to be of a structural nature and therefore, this situation is not likely to change any time soon unless significant steps are undertaken by the government.

[1258] CBSA, *Statement of Reasons concerning the final determinations with respect to the dumping and subsidisation of Certain Steel Piling Pipe originating in or exported from the People's Republic of China*; 15 November 2012.
[1259] CBSA, *Statement of Reasons concerning the final determination with respect to the dumping and the subsidising Certain concrete reinforcing bar originating in or exported from the People's Republic of China, the Republic of Korea and the Republic of Turkey*, 4214-42 AD/1403, 4218-39 CV/138, 23 December 2014
[1260] Some recent examples include: *India* – 'Certain Hot Rolled and Cold Rolled flat products of stainless steel from China' case No. 14/18/2015- DGAD (2015); *USA* – 'Stainless steel sheet and strip from China' (2017); 'Certain Carbon and Alloy Steel Cut-To-Length Plate' (2017); 'Corrosion-Resistant Steel from China' (2016).
[1261] See references to zombie companies in the chapter.

14.3. RAW MATERIALS AND INPUT DISTORTIONS

As explained in Chapter 12, the government has consistently implemented numerous export restrictions on a broad range of raw materials, having a distortive effect on the market.[1262] These export restrictions have also affected several key raw materials in steelmaking.[1263] The restrictions have taken the form of non-automatic export licensing requirements; export duties; quantitative export restrictions (export quotas); and VAT rebates.[1264]

The following examples illustrate the variety of export restrictions that China has imposed on steelmaking raw materials in recent years: [1265]

- Export quotas for coke, coking coal, metal waste and scrap molybdenum and tin;
- Export duties for chromium, crude steel, iron ore, coke, coking coal, manganese, molybdenum, pig iron, steel scrap, tungsten and zinc;
- Export licensing requirements for coke, coking coal, manganese, molybdenum, tin, tungsten and zinc;
- Export taxes and non-refundable VAT on export of ingots and other primary forms of stainless steel.[1266]

Some of these export restrictions have been removed by China as a result of adverse WTO rulings, which found the restrictions to be inconsistent with WTO law.[1267]

In addition, China also imposes export duties on various forms of chromium, ferronickel and tin, as well as quantitative restrictions such as quotas and additional requirements and procedures with respect to the administration and allocation of quantitative export restrictions

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[1262] In addition to the findings of the investigations described below in this section, see other restrictions at: OECD Raw Materials Inventory: http://www.oecd.org/tad/benefitlib/export-restrictions-raw-materials.htm (last accessed 10 October 2017), China's WTO Trade Policy Review of 2016 and the relevant references included in the European Union's request for establishment of a Panel in the WTO dispute *China - Duties and other measures concerning the exportation of certain raw materials*; WT/DS509.

[1263] For a list with the main steelmaking raw materials see OECD. (2012). *Steelmaking raw materials: market and policy developments.* Directorate for Science, Technology and Industry, Steel Committee. https://www.oecd.org/sti/ind/steelmaking-raw-materials.pdf, p. 8-9. (Last accessed on July 2017).

[1264] For a detailed description of what these distortions consist of, see ibid. Chapter 12.

[1265] OECD. (2014). *Export restrictions in raw materials trade: facts, fallacies and better practices*, pp.31-38 and OECD database on export restrictions on raw materials: http://www.compareyourcountry.org/trade-in-raw-materials?cr=oecd&lg=en&page=0 (data for the year 2014); OECD. (2012). *Steelmaking Raw Materials: Market and Policy Developments*, Annexes 1 and 2: https://www.oecd.org/sti/ind/steelmaking-raw-materials.pdf. (documents last accessed on 12 July 2017); CRU Consulting Steelmaking raw materials – key trends - prepared for the 82nd Session of the OECD Steel Committee http://www.oecd.org/industry/ind/82nd_OECD_Steel_Committee_CRU_Consulting.pdf, p.8.

[1266] Commission Regulation (EU) No 627/2011 of 27 June 2011 imposing a provisional anti-dumping duty on imports of certain seamless pipes and tubes of stainless steel originating in the People's Republic of China; para. 21-43.

[1267] See e.g. Appellate Body Report on the case China — Measures Related to the Exportation of Various Raw Materials (WT/DS394/AB/R, WT/DS395/AB/R and WT/DS398/AB/R).

on various forms of tin.[1268] These varying measures, which have spanned over many years, confirm the persistent intervention of the government with respect to raw materials for steelmaking.

Such restrictions often have an impact on the downstream market. This has been corroborated by different trade defence investigations across various jurisdictions:

The Commission, in *OCS from China*[1269], established that the Chinese government exercised significant control over the market for raw materials, in particular coke. The Commission concluded that 'coke (together with iron ore, the major raw material to produce steel) is subject to quantitative restrictions on exports and to an export duty of 40 %. It may therefore be concluded that the Chinese steel market is distorted due to significant State interference'.[1270]

The Commission further established that this distortion had an impact on the price of the steel input:

> *This distortion is reflected in the price paid by the investigated companies for hot-rolled steel coils in the IP. They were found to be significantly lower than international prices. It may therefore be concluded that the production of OCS benefits from abnormally priced hot-rolled steel coils due to government interference which distorts the price of OCS in the PRC. This distortion constitutes a major cost advantage for the Chinese exporting producers as the cost or the major raw material, hot- rolled steel coils, accounts for approximately 80 % of the cost of production.*[1271]

In a previous investigation the Commission found that the Chinese State had a primary role in the setting of prices of raw materials for seamless stainless steel pipes and tubes (namely stainless steel billets, ingots, and round bars). The Commission found that '*the State interferes in the market continuously with the following tools: export tax and no VAT rebate. First, the main raw materials to manufacture seamless stainless steel pipes and tubes, are subject to a 15 % export tax since 1 January 2008. Second, the State does not refund the VAT on exports of those raw materials'*.[1272]

[1268] WT/DS/509: China, Duties and other Measures concerning the Exportation of Certain Raw Materials - Request for the establishment of a panel by the European Union (See relevant Chinese legislation listed therein).
[1269] Council Implementing Regulation (EU) No 214/2013 of 11 March 2013 imposing a definitive anti-dumping duty and collecting definitively the provisional duty imposed on imports of certain organic coated steel products originating in the People's Republic of China, OJ L 73, 15.3.2013, p.1.
[1270] Ibid., para. 25.
[1271] Ibid., 26.
[1272] Commission Regulation (EU) No 627/2011 of 27 June 2011 imposing a provisional anti-dumping duty on imports of certain seamless pipes and tubes of stainless steel originating in the People's Republic of China, OJ L 29.6.2011, p.1, rec. 26.

The Commission concluded that the '*Chinese system of high export duties and no VAT reimbursement for export of raw materials has essentially lead to a situation where Chinese raw material prices continue to be the result of State intervention, and will, in all likelihood, continue to provide in the future a support to the Chinese producers of seamless stainless steel pipes and tubes*'.[1273]

Similarly, other investigating authorities concluded that the raw material market in the steel sector is distorted due to significant state intervention, and that steel prices in China are consequently not the result of free market forces.

In Canada, the CBSA found in *Fabricated Industrial Steel Components from China*[1274] that the prices of raw material steel inputs purchased from SOEs by the Chinese producers were distorted, and that consequently, the prices of steel components were impacted by these distortions. The CBSA thus concluded that *'domestic prices are substantially determined by the government; and that there is sufficient reason to believe that the domestic prices are not substantially the same as they would be in a competitive market'*[1275]. In *Certain Concrete Reinforcing Bar*[1276] the CBSA reached the same conclusion and recalled its consistent findings that the Chinese government exercises significant control over the steel industry.[1277]

The Australian Anti-dumping Commission has also consistently found evidence of significant involvement of the Chinese government in the steel sector.[1278] For example, in *Steel Reinforcing Bar from China*,[1279] the Australian Anti-dumping Commission determined that the government is able to influence the domestic prices of steel products through the

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[1273] Ibid., para. 32.
[1274] CBSA, *Statement of Reasons concerning the final determination with respect to the dumping and the subsidising of Certain Fabricated Industrial Steel Components*; May 2017, paras 177-196.
[1275] Ibid. *Certain Fabricated Industrial Steel Components* at para. 197.
[1276] CBSA, *Statement of Reasons concerning the final determination with respect to the dumping and the subsidising Certain concrete reinforcing bar originating in or exported from the People's Republic of China, the Republic of Korea and the Republic of Turkey*, 4214-42 AD/1403, 4218-39 CV/138, 23 December 2014.
[1277] The CBSA has also issued opinions that the domestic prices are substantially influenced by the GOC and that they are not substantially the same as they would be if they were determined in a competitive market inter alia, in the following cases: *Wire rod sector - Certain galvanized steel wire* (2013); *Steel pipe sector - Certain piling pipe* (2012); *Oil country tubular goods sector - Certain pup joints* (2011); *Hot-rolled steel plate sector - Certain hot-rolled carbon steel plate and high strength low alloy steel plate* (2010); *Flat-rolled steel industry sector - Certain flat hot-rolled carbon and alloy steel sheet and strip* (2010); *Welded pipe sector - Certain carbon steel welded pipe* (2008 and 2011); *Oil country tubular goods sector - Certain oil country tubular goods* (2010); *Oil country tubular goods sector - Certain seamless carbon or alloy steel oil and gas well casing* (2008).
[1278] See inter alia, the following Reports by the Australian Anti-dumping Commission: Report No. 198: *Dumping of Hot Rolled Plate Steel Exported from The People's Republic of China, Republic of Indonesia, Japan, The Republic of Korea and Taiwan, and Subsidisation of Hot Rolled Plate Steel Exported from The People's Republic of China*, September 2013; Report No. 263, Review into Anti-Dumping Measures: *Aluminium Road Wheels Exported from the People's Republic of China*, September 2015; Report No. 301: *Alleged Dumping of Steel Rod in Coils Exported from The People's Republic of China*, April 2016; Statement of Essential Facts No. 316: *Alleged Dumping and Subsidisation of Grinding Balls Exported from The People's Republic of China*, April 2016; Consideration Report No. 355: *Alleged Dumping and Subsidisation of Steel Shelving Units exported by The People's Republic of China*, June 2016.
[1279] Anti-Dumping Commission, Report No. 300: *Alleged Dumping of Steel Reinforcing Bar Exported from The People's Republic of China*, April 2016.

application of VAT rebates and export taxes on steel inputs. In particular, the Australian Anti-dumping Commission established that:

> *The Chinese Government also distorts the domestic price for rebar through the application of export taxes on Chinese billets, which accounts for between 80 to 85 per cent of the total rebar production cost.*[1280]

Depending on the levels on VAT rebates and/or export taxes set by the government on steel inputs and steel products, a Chinese steel producer would have an incentive to sell either domestically or in an export market. As a result, the Australian Anti-dumping Commission concluded that by altering the relative supply of certain steel products in the domestic market, the government would ultimately influence the prices of those products in China.

In Zinc Coated (galvanised) Steel from China, the report by Customs and Border Protection[1281] determined that '*the government has exerted numerous influences on the Chinese iron and steel industry, which have substantially distorted competitive market conditions in the iron and steel industry in China'*.[1282]

In addition, the report further found that through taxes, export and import quotas, and tariffs, the government had influenced the raw materials of the steel products investigated, which resulted in a distortion in the price of the final product. The report concluded that *'prices of galvanised steel and aluminium zinc coated in the Chinese market are not substantially the same as they would have been without the influences by the government*'.[1283]

In *Hot Rolled Steel Plate Steel from China,*[1284] the Australian Anti-dumping Commission found distortions on some of the key raw materials having an impact on the price of the steel product investigated. It attributed the distortions to the government's influence on the steel sector, in particular through the '*imposition of taxes, tariffs, export quotas and other indirect measures including the government's overarching macroeconomic policies and plans, such as the National Steel Policy, a Blueprint for Steel Industry Adjustment and Revitalisation Directory Catalogue and 12th Five Year Plan have impacted on the supply and distorted the cost of the raw materials coke, coking coal, iron ore and scrap metal, which in turn has distorted the price of plate steel'.*[1285]

[1280] Ibid., p. 99.
[1281] The Australian Anti-Dumping Commission administers Australia's anti-dumping system since 1 July 2013. Until then, the CBPA was responsible for Anti-Dumping investigations.
[1282] Australian Customs and Border Protection Service, Report 190, *Dumping of zinc coated (galvanised) steel and aluminium zinc coated steel exported from the People's Republic of China, the Republic of Korea and, Taiwan*, p.166.
[1283] Ibid., p. 167.
[1284] Australian Anti-dumping Commission: Report No. 198*: Dumping of Hot Rolled Plate Steel Exported from The People's Republic of China, Republic of Indonesia, Japan, The Republic of Korea and Taiwan, and Subsidisation of Hot Rolled Plate Steel Exported from The People's Republic of China*, September 2013.
[1285] Ibid., p. 21.

This section has shown the government's consistent intervention in the steelmaking raw materials market, and its market-distortive effects. Numerous investigations in different countries have confirmed that due to these distortions, the prices of the steel products that incorporated these raw materials were not *substantially* the same as they would have been in a market without the government's intervention. Therefore, Chinese steel producers have consistently benefitted from an unfair and artificial advantage.

14.4. CURRENT SITUATION IN THE STEEL MARKET – THE PROBLEM OF OVERCAPACITY

Introduction

In the period 2006-2016, boosted mainly by real estate and large infrastructure projects (and by stimulus packages by the government to overcome the financial crisis, where growth and demand weakened), China increased its steel production capacity by over 675 million mmt. This amounts to around 73% of the worldwide capacity addition in the same period.[1286] In 2005, China's capacity was estimated at around 30% of the world's total steel capacity. By 2015, it already accounted for around 50%[1287] of the total steel capacity. In 2014 the estimations of *overcapacity* in China were estimated at around 300 mmt,[1288] and in 2015 even higher (between 350[1289] and 400 mmt[1290]). To put this figure into context, this amount corresponds to the combined production of the EU, Japan and India (which are the world's three largest producers after China).[1291] Moreover, the figures included in this chapter concerning Chinese production capacity and excess capacity may be significantly underrepresented. There are strong indications of a large amount of production capacity which until now has been consistently underreported.[1292]

[1286] China's crude steelmaking capacity increased from 488.47 mmt in 2006 to 1.164.55 mmt in 2016. See OECD. (2017). *Capacity Developments in the World Steel Industry*; table 1.
[1287] Zhiyao, L. (2016). *State of Play in the Chinese Steel Industry*, Peterson Institute for International Economics, Table 1. https://piie.com/blogs/china-economic-watch/state-play-chinese-steel-industry. (accessed in 10 July 2017).
[1288] OECD. (2015). *Capacity Developments in the World Steel Industry*; http://www.oecd.org/sti/ind/Capacity-Developments-Steel-Industry.pdf, *p.16 (317 mmt);* European Chamber of Commerce in China; *Overcapacity in China: An Impediment to the Party's Reform Agenda, p.16 (328 mmt).* (accessed in July 2017)
[1289] *Steel: Preserving sustainable jobs and growth in Europe*; Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Investment Bank; COM(2016) 155 final; 16.3.2016, p.2 (fn.2).
[1290] Zhiyao, L. (2016). *State of Play in the Chinese Steel Industry*, Peterson Institute for International Economics https://piie.com/blogs/china-economic-watch/state-play-chinese-steel-industry The Economist (Intelligence Unit). 2016. *The implications of steel capacity cuts* http://country.eiu.com/article.aspx?articleid=804209864&Country=China&topic=E (accessed on 10 July 2017).
[1291] World Steel Association. (2016). *World Steel in Figures 2016* https://www.worldsteel.org/en/dam/jcr:1568363d-f735-4c2c-a1da-e5172d8341dd/World+Steel+in+Figures+2016.pdf (Last accessed on 17 July 2017).
[1292] Data for 2016 gathered by the OECD (crude steelmaking capacity of China equal to 1 153 355 thousand tonnes) compared to the official figures provided by China during the Global Forum on Steel Excess Capacity 2017 (capacity of 1 073 330 thousand tonnes) differs by 80 million tonnes. See OECD Half-yearly steel

Regardless of which statistics are cited, the development of production capacity in China has greatly outpaced production, as well as demand,[1293] giving raise to existing unsustainable levels of overcapacity in the world steel market.

Causes

The existence of certain levels of overcapacity in the steel sector is not uncommon and it is inherent, inter alia, to business cycles of the market.[1294] However, sustained high levels of overcapacity throughout the years, where in a competitive market adjustments would have otherwise been made, are a strong indication of government intervention in that market.[1295] As shown in the previous sections in this chapter, this is precisely the situation taking place in China (as recognised by the State Council itself).

The combination of numerous industrial policies applied over a long period (Section 14.1); the relevance of SOEs in the market, the role of State-owned financial institutions, with the associated effect of zombie companies (Section 14.1.2), the provision of a wide range of State support measures (Section 14.2) and other market distortive practices (Section 14.3), have fuelled massive irrational investment and lending in the steel sector. The result is the current unprecedented high levels of overcapacity, including that contributed by 'zombie companies'.

A recent study by the OECD[1296] reflects the situation of the Chinese steel sector, highlighting the key role of SOEs and policies of preferential lending. It concluded that steelmaking SOEs are contributing significantly to capacity growth in the steel sector:

> *A related analysis* prepared for the OECD Steel Committee suggests also that, on average, steelmaking SOEs were less profitable and more indebted than private firms over the last ten years, while also being much larger than their private competitors. At the same time, there are indications that some continued to receive preferential project financing from state-owned banks even as overcapacity was expanding. All this suggests that state ownership and other forms of state support may have contributed to the crisis which has global trade and investment repercussions.[1297]

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statistical report, OECD DSTI/SC(2017)14, page 3 and G20 Global Forum on Steel Excess Capacity, final report 30/11/2017, page 21. OECD report *Capacity developments in the world steel economy* reports 1 164.55 million tonnes of production capacity in China in 2016, which results in a discrepancy of above 90 million tonnes. See OECD (2017), Capacity developments in the world steel economy DSTI/SC(2017)2/FINAL

[1293] OECD. (2016). *Outcomes from the High-Level Symposium on Excess Capacity and Structural Adjustment in the Steel Sector* http://www.oecd.org/sti/ind/steel-excess-capacity-outcomes.htm (accessed on 15 July 2017).

[1294] OECD. (2015). *Excess capacity in the global steel industry: The current situation and ways forward*.

[1295] Ibid., p. 3.

[1296] Kowalski, P. and Rabaioli, D. (2017). *Bringing together international trade and investment perspectives on state enterprises, OECD Trade Policy Papers, No. 201*, OECD.

[1297] Ibid., p.18.

Effects

Amongst other effects, overcapacity causes a surge of exports and depression of steel prices world-wide, and hence destabilises global steel markets.[1298] In addition, overcapacity has also been found to negatively affect profitability.[1299] These negative effects are further amplified due to a situation of weakness in the sector and prospects of slow growth.[1300]

As a consequence, trade remedy investigations (anti-dumping and anti-subsidy) have surged against Chinese steel imports in recent years.[1301] In 2015 and early 2016, the European Commission for instance launched ten new trade defence investigations against unfair trading practices relating to steel imports from China.[1302] Other countries have also launched numerous trade defence investigations against steel imports from China.

Reduction of overcapacity in China's steel sector: previous attempts

The Chinese authorities have acknowledged that the Chinese steel sector is currently facing a serious problem of overcapacity in the steel sector, and is trying to resolve it.[1303] However, as discussed earlier in this chapter, this situation is not new. In the early 2000's, the Chinese authorities began to regard overcapacity as a growing problem. Although the context presented a positive situation of global growth, particularly boosted by a large internal demand for the steel sector, the Chinese authorities were concerned about a likely worsening of the situation in the future. As outlined in Section 14.1.1, there have been several attempts to curb overcapacity in the last years. Some of the most relevant are referred to below:

[1298] *Steel: Preserving sustainable jobs and growth in Europe*; Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Investment Bank; COM(2016) 155 final, 16.3.2016; OECD. (2015). *Evaluating the Financial Health of the Steel Industry*

[1299] OECD, (2015), *Evaluating the Financial Health of the Steel Industry*; Kowalski, P. and Rabaioli D. (2017). *Bringing together international trade and investment perspectives on state enterprises*, OECD Trade Policy Papers, No. 201, OECD.

[1300] OECD. (2016). *High-Level Meeting: Excess Capacity and Structural Adjustment in the Steel Sector*. *Background Note No. 2 – Capacity Developments in the World Steel Industry*. 18 April 2016, Brussels, Belgium. Available at: http://www.oecd.org/sti/ind/Background%20document%20No%202_FINAL_Meeting.pdf (accessed on 15 July 2017).

[1301] European Commission – DG TRADE - *Trade Defence Statistics*: http://trade.ec.europa.eu/doclib/html/156053.htm (last accessed 12 September 2017): Measures on Iron & Steel sector in the EU amounted to 55% and 28% of the total AD and CVD cases initiated in the period 2012-2016 (most of which, on Chinese imports). In 2016, steel cases represented 87% of the total investigations initiated by the Commission. Amongst WTO members (excluding the EU) these amounted to 32% and 51% of the AD and CVD cases initiated in that period.

[1302] *Steel: Preserving sustainable jobs and growth in Europe*; Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Investment Bank; COM(2016) 155 final; 16.3.2016; p.3

[1303] It is acknowledged, inter alia, in The Plan for Adjusting and Upgrading the Steel Industry. However, a decade earlier, in 2006, the State Council had issued the Circular on Accelerating the Structure Adjustment of the Industries with Production Capacity Redundancy, where the overcapacity problem was already acknowledged for, inter alia, the iron and steel sector.

As noted above, in 2003 the State Council issued a Notice highlighting the incipient problem of overcapacity in some sectors, including steel.[1304] In 2006, the State Council issued the Circular on Accelerating the Structure Adjustment of the Industries with Production Capacity Redundancy,[1305] warning about serious risks of further aggravation of the problem. It also issued the NDRC Notice on Preventing the Blind Re-expansion of High-Energy Consuming Industries.[1306] In 2009, through the Blueprint for Steel Industry Adjustment and Revitalisation and the Urgent Notice of the MIIT requiring Local Governments to Curb Excessive Growth in Crude Steel Output,[1307] the existence of even higher levels of overcapacity continued to be acknowledged.

Further attempts were made to resolve the overcapacity problem in 2013 through the Guiding Opinion of the State Council Regarding Resolving the Contradiction of Serious Overcapacity,[1308] and in 2015 through the Circular on Measures for the Implementation of Capacity Replacement in Industries with Serious Overcapacity.[1309]

The same concerns on the effectiveness of such policies that exist today have been previously raised.

The limited attempts that were made to reduce overcapacity in accordance with the 2013 plan were largely ineffective. For example, in late 2013, China's Hebei province staged an event during which demolition squads blew up blast furnaces owned by 15 mills, all shown on Chinese state television. According to the Wall Street Journal, however, '[a]*ll of the furnaces targeted for destruction turned out to be so outmoded that the companies that owned them didn't consider them spare capacity, steel-industry officials* [said], *meaning they didn't help reduce the province's extra volume*.' In part due to the lack of progress closing capacity in Hebei, '*there is no reason to assume that* [the government's 80-million tonne closure] *target will be met,*' let alone the larger level of capacity closure envisioned by China's newly announced plan.*[1310]*

[1304] Notice of the General Office of the State Council Issuing the Several Opinions of the National Development and Reform Commission and Other Agencies Regarding Checking Blind Investment in the Steel, Aluminium, and Cement Sectors, Guo Ban Fa [2003] No. 103 (Dec. 23, 2003).
[1305] Circular on Accelerating the Structure Adjustment of the Industries with Production Capacity Redundancy, No. 11 (2006) of the State Council.
[1306] NDRC Notice on Preventing the Blind Re-expansion of High-Energy Consuming Industries, No. 1332 (2006), NDRC.
[1307] Urgent Notice of the MIIT requiring Local Governments to Curb Excessive Growth in Crude Steel Output, No. 191 (2009) of the MIIT.
[1308] Guiding Opinion of the State Council Regarding Resolving the Contradiction of Serious Overcapacity, Guo Fa [2013] No. 41 (Oct. 6,2013) (Guo Fa [2013] No. 41).
[1309] Circular on Measures for the Implementation of Capacity Replacement in Industries with Serious Overcapacity, No. 127 (2015), MIIT.
[1310] Price, A. Weld, C. El-Sabaawi, L. and Teslik, A. (2016). *Unsustainable: Government intervention and overcapacity in the global steel industry*, Wiley Rein LPP, pp. 7-8.

The most recent official commitment to reduce steel overcapacity can be found in the 13th FYP for Steel, whereby the government seeks to reduce China's steel overcapacity by 100-150 mmt by the year 2020.

Several conclusions can be drawn from the previous attempts by Chinese authorities to curb overcapacity in the steel sector:

- *Root of the problem*: In the first place, the government recognised, for more than a decade, that overcapacity has been a problematic issue that could grow out of control. This has in fact happened. In this regard, it is important to highlight that, with these successive plans/directives, the Chinese authorities have de facto directly contributed to exacerbating a problem that was created by their own policies.

- *Ineffective attempts to solve the problem:* The plans and directives have focused on the reduction of outdated/backward capacity and the closure of mills/furnaces of a certain (small) size. At the same time, an upgrade of the production system (moving towards the production of higher added value steel products), and a higher level of concentration in the sector have been encouraged, seeking to have a few 'national champions' in the sector.[1311] The result is that, despite eliminating certain backward capacity, overall the total capacity has increased, therefore rendering the overcapacity reduction policies ineffective.

Therefore, throughout this time, not only has China been unable to meet the capacity reduction requirements in the past, it has continued to build-up massive overcapacity throughout the years,[1312] driven by the very measures directed at reducing it.

In this context, the current target for capacity reduction set out in the 13th FYP for Steel and the related policies has come under close scrutiny. A major obstacle identified for an effective implementation of the government's policies has been the absence of market-based policies which in turn allow local governments to resist plant closures in order to avoid the consequences of loss of employment, etc.[1313]

[1311] See HRF at 247: '[…] *it confirmed that there is a governmental policy in the PRC to develop large national champions (mostly state-owned) in the steel industry over smaller (mostly private) mills*'. Also, in line with these objectives, the merger between Baosteel and Wuhan (both SOEs), gave rise to the world's second largest steel producer: Baowu. See Reuters. (2016) *China completes merger that creates nation's biggest steel company* http://www.reuters.com/article/us-china-steel-m-a-idUSKBN13Q3B0 (Last accessed on June 2017).
[1312] OECD. (2017). *Capacity developments in the world steel industry*; Table 1: Crude steelmaking capacity developments.
[1313] OECD. (2015). *Excess capacity in the global steel industry: the current situation and ways forward*; The Economist Intelligence Unit. (2016). *The implications of steel capacity cuts*: http://country.eiu.com/article.aspx?articleid=804209864&Country=China&topic=E; European Chamber of Commerce in China. (2016). *Overcapacity in China: An Impediment to the Party's Reform Agenda*, p.16; Australian Anti-dumping Commission. *Analysis of steel and aluminium markets report to the Commissioner of the Anti-dumping Commission*, p. 48, 2016; Alloway, T. (2015). *Why China's Steel Mills Won't Cut Back Production*, Bloomberg https://www.bloomberg.com/news/articles/2015-11-24/why-china-s-steel-mills-won-t-cut-back-on-production ; Stanway, D. and Lian, R. (2012) *Analysis: China steel mills too big to fail – or succeed*,

Although it is still too early to assess whether by the year 2020 China will have achieved its goals of reducing the overall production capacity by 100-150 mmt, some concerns have already been raised about the effectiveness of approach and whether the target will be met (see Section 4.2.5).[1314]

14.5. CHINA IRON AND STEEL ASSOCIATION

CISA is the association of '*119 members whose steel output, sales income and staff number account respectively for 92.6%, 90% and 75% of the total domestic steel industry'*.[1315] According to its articles of association, CISA '*represents and protects its members' legal rights and interests*' while following '*the Party's line, orientations and policies'*.[1316] CISA shall '*aim at serving enterprises, the industry, the government the society (…) stick to the market orientations, actively provide services, reflect demand, regulate operations, set up and improve industry coordination and self-discipline mechanisms, and strive to play a the role of a bridge and a link between the government and enterprises and business entities'*.[1317] CISA plays a role on the domestic, as well as the international, iron and steel business as it shall '*keep improving China's steel industry's competitiveness on the domestic and foreign markets, foster the steel industry's scientific development and strive to build [China as] a strong steel power'*.[1318]

Furthermore, it is worth noting that CISA shall '*receive business guidance and be submitted to the supervision and management of both the State Council SASAC and the Ministry of Civil Affairs*'[1319] and shall '*promote technological innovation, management innovation and product development, organise the development of industry generic technologies as well as the dissemination of technological achievements'*.[1320] Besides, CISA shall also '*receive mandate*

Reuters, 3 May 2012. https://www.reuters.com/article/us-china-steel/analysis-china-steel-mills-too-big-to-fail-or-succeed-idUSBRE84203620120503 (Last accessed on July 2017).

[1314] See, inter alia: Schuman, M. (2016). *A Steel Mill Lives Again, in a Setback for China* The New York Times https://www.nytimes.com/2016/06/10/business/international/a-steel-mill-lives-again-in-a-setback-for-china.html?_r=0; Bloomberg News. (2016). *China to Accelerate Steel Capacity Cuts After Missing Targets* https://www.bloomberg.com/news/articles/2016-08-16/china-to-accelerate-steel-capacity-cuts-after-missing-targets; Yap, C.W. (2016). *China's Zombie Companies Stay Alive Despite Defaults*. Wall Street Journal https://www.wsj.com/articles/DJFDBR0120160712ec7cd80af; Bloomberg News. (2016) *China Bid to End Steel Glut Failing as Rally Revives Mills* https://www.bloomberg.com/news/articles/2016-09-26/china-bid-to-end-steel-glut-failing-as-rally-revives-idled-mills; Zhang, Y. and Wang, W. (2016). *Transformation of steel industry turns tricky* China Daily http://europe.chinadaily.com.cn/business/2016-05/30/content_25525733.htm; Platts. (2016). *Why Chinese steel output is up despite capacity cuts* : http://blogs.platts.com/2016/11/22/china-steel-output-capacity-cuts/ ; Economist Intelligence Unit (2017): 'China's supply-side structural reforms: Progress and outlook' http://www.scmp.com/news/china/economy/article/1944568/zombies-return-why-are-steel-firms-china-coming-back-dead (Last accessed on 15 July 2017).

[1315] See China Daily, *China Iron and Steel Association* http://topic.chinadaily.com.cn/index/special/sid/264 (accessed on 16 October 2017).

[1316] See CISA Articles of Association, Article I.3.

[1317] Ibid.

[1318] Ibid.

[1319] Ibid., Article I.4.

[1320] Ibid., Article II.5.

from the Government administration to proceed to prior progress, economic and feasibility studies concerning the participation in industry-related major investments transformation and development projects.'[1321]

The 13TH FYP on Steel, Section V.4, explicitly mentions CISA's role as to the implementation of the Plan: '*China Iron and Steel Association and other sectoral organisations shall play their bridging and linking role, and, at the same time, reflect the iron and steel sector's new situations, new problems emerging in the course of the implementation of the present plan as well as formulate policy suggestions.*'

In March 2017 'Enterprise alliance of China's steel sector for the International Production Capacity Cooperation' was launched. CISA participates in the project along with NDRC.[1322] As an example of local government involvement in resolving the issue of overcapacity, CISA in active in transferring steel production capacity of 5 million tonnes from Hebei to overseas locations by the end of 2017.[1323]

14.6. CHAPTER SUMMARY

The steel industry is regarded as a key/pillar industry by the Chinese government. This is confirmed in the numerous plans, directives and other documents focused on steel, which are issued at national, regional and municipal level. The government guides the development of the sector in accordance with a broad range of policy tools and directives related, inter alia: to market composition and restructuring, raw materials, investment, capacity elimination, product range, relocation, upgrading, etc. Through these and other means, the government directs and controls virtually every aspect in the development and functioning of the sector. The different plans also show that SOEs will be a key instrument through which the government envisages developing the steel sector in the coming years (see Section 14.1.1). As described in Chapter 5, SOEs serve the government's strategic industrial policies. In the steel sector, the government seeks to promote the creation of ever-larger steel producers ('national champions'). This is achieved through policies intended to shape the structure of the market, e.g. through mergers and regulation of market access (see Section 8.2). In addition, the financial institutions, in particular those that are state-owned, play a key role in implementing

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[1321] Ibid.
[1322] See CISA website: http://www.chinaisa.org.cn/gxportal/DispatchAction.do?efFormEname=ECTM40&key=BGcNMl41WTgFZA45UTZRMFczUDAAZFNmUWVTZQRlBzJXRFoVDBdRYVBBVxADFAZk and MOFCOM website: http://fec.mofcom.gov.cn/article/tjgjcnhz/xgzxhlj/201703/20170302539890.shtml (accessed on 11 December 2017).
[1323] See Notice of the General Office of the People's Government of the Hebei Province regarding the promulgation of the Work and Promotion Plan for the transfer overseas of excess capacities in steel, cement, glass and other competitive industries 2014/97, 河北省人民政府办公厅关于印发河北省钢铁水泥玻璃等优势产业过剩产能境外转移工作推进方案的通知, available at: http://www.hbdrc.gov.cn/common/ueditor/jsp/upload/20141204/94761417678224126.pdf (accessed on 16 October 2017).

the government's policies in the steel sector. These financial institutions, following the government's direction, provide access to finance thereby implementing the government's policy objectives (see Section 14.1.3). These elements combined present a picture of a sector heavily influenced by the government, resulting in significant distortions in the market. In this regard, numerous investigations have confirmed that Chinese steel producers benefit from a wide array of State support measures and other market distortive practices such as export restrictions affecting raw materials and inputs (see Sections 0 and 14.3).

The overarching control of the government prevents free market forces from prevailing in the steel sector in China. The current problem of overcapacity is arguably the clearest illustration of the implications of the government's policies and the distortions resulting therefrom. The current situation of overcapacity triggered a surge of low-priced Chinese exports; causing a depression of steel prices globally and having a negative impact on, inter alia, the financial situation of steel producers worldwide. Consequently, the number of trade defence investigations against Chinese steel imports in different jurisdictions continues to rise (see Section 14.4). While the government has committed to address the overcapacity problem, in particular through the 13th FYP for Steel, it remains to be seen whether this and other targets for the sector are successfully met.

15. ALUMINIUM SECTOR

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15.1. REGULATORY FRAMEWORK

The government plays a key role in the development of the Chinese aluminium sector. The plans, directives, guidelines and other documents described in this section show the extent of influence and intervention exerted over the sector.

15.1.1. 13TH FYP

Unlike the 12th FYP, the 13th FYP does not contain specific provisions on aluminium. It does envisage, for the non-ferrous metal industry in general, a strategy of promoting cooperation on international production capacity and equipment manufacturing – most notably by fostering overseas investment and guiding companies to 'go abroad together'. To achieve these goals, the plan confirms that it will enhance supporting systems related to taxation, finance, insurance, investment and financing platforms, as well as risk assessment platforms.

15.1.2. 13TH FYP FOR THE NON-FERROUS METALS INDUSTRY

The Non-Ferrous Metal Industry Development Plan (2016-2020) sets out specific policies and targets that the government aims to achieve for a number of non-ferrous metals industries[1324], including aluminium.

Product upgrade and innovation

The Plan aims at upgrading the range of product types produced by the Chinese aluminium industry. To this end, the plan states that Chinese producers shall be able to supply more than 70% of the domestic demand for aluminium products used in electronics, power batteries materials and high-performance hard alloys, thereby covering the demand for high-end equipment of the new generation of IT technologies. Overall, the Plan envisages that the variety of products supplied by Chinese producers shall effectively increase.

The Plan also focuses on improving the performance and quality of key high-end materials including aluminium, used in large aircraft and passenger cars, materials used for polished wafers and high-purity targets for integrated circuits, power battery materials for new energy cars, titanium materials used for oil and gas exploitation, and deep-sea resistant, shock-resistant and corrosion resistant materials used in shipbuilding and marine engineering equipment.

Moreover, the Plan provides that the implementation of smelting and casting of large standard aluminium-lithium alloy ingots shall be speeded up. In this respect, the Plan sets out as an objective to obtain, by 2020, a stable supply of high-performance light alloys.[1325]

Other objectives impacting the aluminium sector include:[1326]

- the development of, inter alia, high performance light alloy materials, non-ferrous metals for electronic materials, non-ferrous metals for new energy materials;
- raising the quality and homogeneity of materials;
- lowering costs;
- raising the mid & high range effective supply capacity and level.

The Plan states that eligible enterprises shall be supported to set up 'aluminium-power-grid' integrated industry chains in order to increase the competitiveness of the industry. At the same time, the Plan encourages companies in the aluminium sector to set up collaborative R&D platforms and to make full use of the functionalities derived from Internet, e.g. e-commerce, big data, cloud platforms, etc.[1327]

[1324] For provisions of the Plan concerning other metals, see Section 12.3.1.2.
[1325] Non-Ferrous Metal Industry Development Plan, Section III-3.
[1326] Ibid.
[1327] Ibid., Section V-4.1.

The Plan envisages the implementation of a number of large science and technology programmes and projects; an increase in the innovation capacities related to technologies in key links of the industry chain; the promotion of national manufacturing innovation centres, laboratories, national industry technology research centres, and national product quality inspection centres. In addition, enterprises are encouraged to set up highly efficient collaborative platforms for, inter alia, R&D and design.[1328]

As an overall objective, the Plan states that Chinese producers shall enter the domestic and international high-end product supply chain.

Various supporting measures

The Plan envisages several support measures for companies in the non-ferrous metal sector. Some examples are outlined below:

> *Support enterprises so that they introduce production-line monitoring, smart manufacturing, and logistics systems; foster a number of leading enterprises and non-ferrous metal fine products, with optimal quality and prices as well as improved marketing services; guide enterprises to speed up innovation and to improve and stabilise product quality; consider those companies having established a brand reputation and international competitiveness as pillars;*[1329]

The Plan also envisages; supporting enterprises to improve their energy consumption, material consumption, technological level, product quality, labour productivity etc. in order to converge towards the domestic and foreign advanced enterprises' levels; supporting non-ferrous metal enterprises to comply with the sectors' regulations and conditions, energy consumption and environmental protection standards; to develop direct electrical supply deals; supporting electrical power users to negotiate lower grid utilisation charges and back up capacity charges with electrical grid enterprises.

Additional support is also to be provided in order to:[1330]

- promote the implementation of key national technological programmes, key national R&D plans,
- foster civil/military cooperation and mutual benefits as regards resources,
- strengthen civil/military collaborative innovation,
- set up alliances for technological innovation,
- unite forces so as to ensure a breakthrough in key general technologies for priority sectors;
- develop new types of subsidies granted after the technological achievement,
- encourage enterprises to innovate and conquer new markets;

[1328] Ibid, Section IV-1.
[1329] Ibid, Section IV-1.iv.
[1330] Ibid, Section V-3.

- support the development of non-ferrous metal new materials;
- study an insurance compensation mechanism applicable to the first production series of new materials.

In addition, with regard to IT development and industrialisation, the Plan envisages to:[1331]

- promote the establishment of standards for IT development and industrialisation comprehensive technologies,
- ensure the expansion of applications such as on-(production)-line monitoring, smart optimisation of the production process, simulation and modelling, etc.
- ensure that digitalisation (NC command) of dressing and smelting and of other key processing technologies shall exceed 80%,
- raise the share of enterprises integrating comprehensive technologies from 12% to 20%;
- raise the share of enterprises integrating management and control technologies from 13% to 18%;
- raise in the share of integrating production, supply and sales technologies from 16% to 22%.

In addition, the Plan provides for various forms of financial support, such as: [1332]

- strengthening the connexions between fiscal, tax, financial, trade policies and industry policy;
- supporting connexions between banks and enterprises as well as cooperation between the production and financial sectors;
- provided risks remain controllable and business remains sustainable, expanding the financial support to backbone enterprises that continuously comply with regulations, environmental protection and safe production standards and have market perspectives and that are operationally efficient;
- fully using the already existing funding channels;
- encouraging local governments and private capital to expand investments;
- studying an insurance compensation mechanism applicable to the first production series of new materials; and
- increasing the financial support to eligible major international cooperation programmes.

Role of SOEs

The Plan calls for swift development of the mixed ownership system and a boost to SOEs vitality. [1333] In relation to the implementation, the Plan envisages that all development

[1331] Ibid., Section III-3.v.
[1332] Ibid., Section V-5.
[1333] Ibid., Section V-3.

planning exercises concerning the non-ferrous metal industry, at the relevant regional and central level SOEs, shall comply with the present Plan:

- they shall organise and set out the plan's implementation and
- shall take the relevant actions to implement the tasks.

Stockpiling policy

The Plan continues to provide for the possibility of stockpiling non-ferrous metals and thus follows previous plans.[1334] In particular, it includes the possibility to explore the setting up of commercial reserves for non-ferrous metals and to build a reserve mechanism gathering both government and enterprises' reserves.

Security of resources

The Plan provides that resource exploration and exploitation shall be further developed, and that security of resources, including aluminium, shall be improved.[1335]

Quantitative targets

The Plan sets specific targets such as reducing the power consumption for electrolytic liquid aluminium by 150 Kwh/tonne by 2020; increasing of the ratio of recycled aluminium over the total volume of aluminium supplied (from 15% to 20%); and reaching a capacity utilisation level in electrolytic aluminium production of 80%.

Other quantitative targets in the Plan include: increasing the ratio of sales of processed products over the whole amount of sales by 10%; increasing the ratio of R&D expenditures to the operational business income of major enterprises from 0.6% to 1%; and reducing several energy consumption ratios.[1336]

Structural adjustments and elimination of outdated capacity

The Plan calls for a stricter control on new smelting facilities for aluminium, and for implementation of the regulations related to the State Council Guiding Opinion on Solving Serious Overcapacities (2013, No. 41). In this regard, the Plan envisages that production capacity conversion plans, with the aim of maintaining or reducing current capacity, shall be applied inter alia, to electrolytic aluminium facilities. In addition, the Plan overall seeks to achieve the effective withdrawal of low-efficiency production capacities and to transfer ‘unreasonable production capacities’ towards regions which have an advantage in terms of resource, energy and environmental capacity.[1337]

[1334] For a more detailed analysis on the stockpiling policy, see Section 15.3.
[1335] Non-Ferrous Metal Industry Development Plan, Section III-3.iii.
[1336] Ibid., Section III-Table 2.
[1337] Ibid., Section IV-2.ii.

The Plan encourages non-ferrous metal enterprises to develop upstream and downstream alliances and restructuring within the sector and across sectors, to increase the level of concentration of the sector and to strengthen business integration and process re-engineering. Lastly, the plan also provides for an implementation of preferential tax policies applicable to mining and tax policies applicable to mergers and restructurings.

Policies concerning geographical distribution

The Plan encourages companies involved in processing key non-ferrous metals, and located in China's Eastern, Southern and North-Eastern regions, to change from focusing on size expansion to fully exploiting the equipment's efficiency, raising product quality and expanding towards spare parts manufacturing, semi-finished products, manufactured products and production services.

Projects for resource exploitation

To increase the capacity of resources supply, the Plan includes a focus on projects affecting bauxite mines and alumina.[1338]

Electricity-related measures

In the context of stricter controls on the overall electrolytic aluminium production capacity, the Plan envisages exploring the development of several local electrical power grid test areas in: Baise (Guangxi), Holingol (Inner Mongolia), Baotou (Inner Mongolia), Wucaiwan (Xinjiang), Lanzhou-Lianhai (Gansu), Qingtongxia (Ningxia) and the Eastern part of Ningxia, Central Guizhou and the Southwestern part of Guizhou, Yuncheng and Luliang (Shanxi), the North-western part of Henan, and other areas fulfilling the necessary conditions.[1339]

Regarding the pricing policy for electricity, the Plan states that an electrical power price policy, with different price levels, shall be set up for the electrolytic aluminium sector. The Plan also provides that eligible enterprises would be supported to set up an industry chain covering an 'aluminium-electrical power-grid'. In addition, the Plan seeks to reduce the cost of electrical power utilisation and to improve the enterprises' economic benefits.

15.1.3. STANDARD CONDITIONS APPLICABLE TO THE ALUMINIUM INDUSTRY

Standard Conditions Applicable to the Aluminium Industry (2013) ('Standard Conditions')[1340] replaced the previous Entry Conditions Applicable to the Aluminium Industry from 2007 in order to '*speed up the aluminium industry structural adjustment, standardize the enterprises' production and business operations*, [and] *curb the disorderly*

[1338] Ibid., Section IV-5, Table 11.
[1339] Ibid., Section V-4.
[1340] Specifications for the Aluminium Industry (Notice 36), issued by MIIT on 18 July 2013, http://www.gov.cn/gzdt/2013-07/24/content_2454273.htm (accessed on 16 October 2017).

expansion of the aluminium smelting capacities'[1341] The MIIT, in its interpretation document, goes a little bit further and states that these standard conditions are expected to '*speed up the aluminium industry structural adjustment and upgrade'*[1342] as well as to enhance electrolytic aluminium enterprises' competitiveness by '*encouraging electrolytic aluminium enterprises to proceed to restructuring and ensure the integration of hydro-power/aluminium, of coal-power/aluminium or aluminium/power'.*[1343]

The Standard Conditions introduce a general quantitative threshold: '[t]*he size of alumina projects must exceed 800 000 tonnes/year […]. As to alumina projects using fly-ash, […] their production capacity shall exceed 500 000 tonnes/year'*[1344] as well as qualitative requirements concerning products '*the quality of bauxite products must comply GB/T24483-2009, the quality of alumina products must comply with YS/T803-2012'*[1345] and equipment. The production process is also regulated and it is interesting to note that a distinction is made according to the origin of raw materials: '*as regards alumina projects using domestic bauxite, the supporting bauxite mine shall account for 85% of the bauxite supply and resource security shall be ensured for more than 30 years; as regards alumina projects using imported bauxite, the security of the overseas bauxite resource supply shall be ensured in the long term and the resource shall be covered by a long-term contract of more than five years […] and cover more than 60% of the needs'.*[1346]

Furthermore, the Standard Conditions introduce requirements regarding energy consumption, resource consumption and environmental protection.[1347]

According to the Standard Conditions, the MIIT is the authority '*in charge of the standardisation and management of the aluminium industry*'[1348] and publishing the list of the enterprises authorised to operate in the aluminium industry.[1349]

[1341] See Standard Conditions, Introduction.
[1342] MIIT Interpretation of the Standard conditions applicable to Aluminium, Section II, emphasis added. Document available at: http://www.gov.cn/gzdt/2013-07/24/content_2454273.htm (accessed on 16 October 2017).
[1343] Ibid., Section VIII.
[1344] Standard conditions, Section I.2.
[1345] Ibid., Section II.1.
[1346] Ibid., Section I.2.
[1347] Ibid., Sections III, IV and IV.
[1348] Ibid., Section VII.1.
[1349] See for instance the 2014 list, first batch http://www.miit.gov.cn/n1146295/n1652858/n1652930/n4509607/c4512413/content.html , and more recently the 2016 list, third batch, http://www.miit.gov.cn/n1146285/n1146352/n3054355/n3057569/n3057573/c5214433/content.html (accessed on 16 October 2017).

15.1.4. NON-FERROUS METALS INDUSTRY ADJUSTMENT AND REVITALIZATION PLAN

The Non-Ferrous Metals Industry Adjustment and Revitalization Plan (2009)[1350] was adopted to alleviate the negative effects on the non-ferrous metal industry of the financial crisis.

The key objectives set out in the plan include, inter alia, the following:

Production volume control

The Plan states that the national industrial policy shall be strictly implemented and, through the adoption of comprehensive measures, production volume shall be controlled and should return to 'normal levels'. In the same vein, a reduction of 80 000 mt of backward capacity in electrolytic aluminium is envisaged.[1351]

Restructuring of the industry

The Plan envisages the creation of 'three to five' large groups, with the top ten producers accounting for 70% of domestic production.[1352] The Plan calls for support for trans-regional large enterprise mergers and acquisitions. The Plan emphasizes the support for aluminium companies. It promotes the creation of joint ventures in the sector, extension of the industrial chain, and development of high level processing and enhanced competitiveness.[1353]

Raw materials

The Plan provides for strengthening the development and use of jointly mined coal and aluminium resources and developing an alumina production capacity of 1 million metric tonnes.[1354]

Improvement of the export tax policy

The Plan states that 'high capital' exports shall continue to be controlled, and that flexible tax export policies shall be implemented to support exports of high added-value processing goods, thus stimulating the indirect export of non-ferrous metals (high value-added export tax rebate).[1355]

[1350] The Non-Ferrous Metals Industry Adjustment and Revitalization Plan, Guo Fa [2009] No. 14 (12 May 2009).
[1351] Ibid., Section II-C/1 and 2.
[1352] Ibid., Section II-C/4.
[1353] Ibid., Section III- A.
[1354] Ibid., Section II-C/6.
[1355] Ibid., Section III-A.

Security of resources

To improve the self-sufficiency of resources, the plan aims at developing domestic and overseas mining resources. To this end, qualified enterprises would be supported to make overseas investments or engage in joint venture mining operations.[1356]

Stockpiling

The Plan provides that a state purchase and storing mechanism of non-ferrous metals (including aluminium) should be set up.[1357]

Technological innovation and R&D projects

The Plan envisages the provision of subsidies in the form of loans to support R&D and technological innovation. It also envisages financial incentives to increase energy-saving technological support.[1358]

Financing policy

The Plan outlines the objective of increased financing support for non-ferrous metal companies, in line with national industrial policies, by the issuance of, inter alia, shares, corporate bonds and bank loans. [1359]

Planning and implementation

The relevant departments within the State Council guide, supervise and evaluate the implementation of the plan. In addition, regions are required, in accordance with the Plan, to determine the relevant objectives, tasks and policy measures to be adopted in order to achieve substantial results in its implementation.[1360]

15.1.5. ENTRY CONDITIONS APPLICABLE TO THE ALUMINIUM INDUSTRY

Entry Conditions Applicable to the Aluminium Industry, issued by the NDRC in October 2007[1361] and ultimately repealed in 2016,[1362] had, as its main objectives, to promote the development of the aluminium industry and to reduce greenhouse emissions. Some of the main requirements are outlined below:

[1356] Ibid., Section III-E.
[1357] Ibid., Section IV-B.
[1358] Ibid., Section IV-C.
[1359] Ibid., Section IV-I.
[1360] Ibid., Section V.
[1361] Entry Conditions Applicable to the Aluminium Industry, NDRC, No. 64 (2007).
[1362] See http://www.ndrc.gov.cn/zcfb/zcfbl/201601/t20160113_771254.html and http://www.ndrc.gov.cn/zcfb/zcfbl/201601/W020160113386466096257.pdf.

Quantitative requirements

- New bauxite mining projects: must have a minimum output capacity of 300 000 tonnes per year and a lifespan of 15 years. Mining projects exceeding RMB 500 million shall be ultimately approved by the Central Government (after prior approval by the provincial government and NDRC).
- New alumina projects: must have the approval of the NDRC. If they use domestically-produced bauxite, the capacity should exceed 800 000 tonnes and have a lifespan of 30 years.
- Alumina projects using imported bauxite must have supplied bauxite for at least five years through a joint-venture, which is able to supply 60% of the bauxite needed for production, and such alumina projects must be capable of producing at least 600 000 tonnes per year.
- Secondary aluminium projects must have a minimum capacity of 500 000 tonnes per year.
- Aluminium processing projects must have a minimum capacity of 100 000 tonnes per year.

15.1.6. GUIDELINES FOR ACCELERATING THE RESTRUCTURING OF THE ALUMINIUM INDUSTRY

The Guidelines for Accelerating the Restructuring of the Aluminium Industry,[1363] issued by the NDRC in April 2006, regard aluminium as a fundamental product in the development of the national economy. The Guidelines set out the policies to achieve structural adjustment in the industry, where systemic problems such as overcapacity had been identified.

The Guidelines state that, in implementing the Industrial Development Policy approved by the State Council, specific objectives in the following areas shall be achieved:

Enhance the concentration in the industry

The Guidelines provide that a favourable environment shall be created in order to accelerate mergers and acquisitions in the sector to create larger groups.[1364]

Access to financial capital

The Guidelines instruct financial institutions to continue providing loans, in accordance with national macro-control, industry and credit policies, to those companies which meet the relevant state industry policies.[1365]

[1363] Guidelines for Accelerating the Restructuring of the Aluminium Industry, Fa Gai Yun Xing (2006) No.589.
[1364] Ibid., Section 3-2.
[1365] Ibid., Section 3-3.

Organisation of the industry

The Guidelines encourage the exploitation of overseas bauxite resources and the improvement of Chinese-exploited overseas alumina resources, with the objective that in ten years, these resources would satisfy 50% of total domestic demand.[1366]

In addition, the Guidelines call on regional administrations (in particular in Henan and Shanxi provinces), to analyse ongoing local alumina projects and report to the NDRC, to ensure that these projects meet all the relevant industry, market access, land use and environmental regulations. The Guidelines also seek to prevent any blind construction of electrolytic aluminium projects.[1367]

Strict control of exports of electrolytic aluminium

According to the Guidelines the VAT rebate and restrictions policy on electrolytic aluminium shall continue to be applied.[1368]

Elimination of outdated capacity

The Guidelines call for a swift elimination of backward capacity of electrolytic aluminium. To this end, the Guidelines promote the creation of larger projects combined with the closure of smaller facilities, and the upgrading and reconstruction of facilities with outdated capacities.[1369]

Other documents showing the degree of the government's intervention include:

- Guidelines of the State Council on Resolving the Contradiction of Serious Overcapacity (2013);
- Notice of the State Council on Further Strengthening the Elimination of Backward Production Capacities (2010);
- China's Aluminium Industry Layout and Restructuring Proposal (2007);
- Circular on Accelerating the Restructuring of the Sectors with Production Capacity Redundancy (2006).

15.2. SOEs PRESENCE IN THE MARKET

China is the largest aluminium producer in the world,[1370] with several large SOEs amongst the top individual producers worldwide.[1371] According to estimates, SOEs account for more than

[1366] Ibid., Section 3-6.
[1367] Ibid., Section 3-8.
[1368] Ibid., Section 3-7.
[1369] Ibid., Section 3-8.
[1370] See World Aluminium Statistics, available at: http://www.world-aluminium.org/statistics/ (last accessed on 15 July 2017).

50% of the total primary aluminium output in China.[1372] A recent study of the non-ferrous metal industry in China also points in the direction of SOEs accounting for a dominant share of the domestic market.[1373] This being said, the last years have shown an increase in capacity which is e attributed partly to privately-owned companies, driven in particular by the rapid growth of China Hongqiao Group. The aluminium production capacity amongst the main SOEs has also increased in this period, though to a lesser extent.[1374] Overall, SOEs have a significant presence in the Chinese aluminium market, especially in the primary aluminium segment.

The strong intervention of the Chinese government in SOEs has been described in detail in Section 5. The current trend of an increasing level of intervention (see Section 3.4) are also affecting companies in the aluminium sector. The following example illustrates well the situation:

In 2017 a Chinese state-owned aluminium producer, China Aluminum International Engineering Corporation Limited ('Chalieco'), amended its Articles of Association giving more prominence to the role of party cells within the company (see Section 3.4). It included a whole chapter on the Party Committee, and Article 113 thereof states: *'In deciding major corporate issues, the Board shall consult the Party Committee of the Company in advance.'*[1375]

15.3. SPECIFIC POLICY TOOLS IMPLEMENTING THE GOVERNMENT'S OBJECTIVES

As outlined in Section 15.1, the government has continuously intervened in the market by applying a broad variety of different instruments. Evidence of these numerous interventions can be found in the various trade defence investigations carried out by different authorities showing the Chinese government's determination to strictly control and influence the Chinese aluminium sector.

Concrete examples of how the government's intervention has affected and continues to affect the Chinese aluminium sector are described below:

[1371] United States International Trade Commission (USITC). *Aluminium: Competitive conditions affecting the US industry*, table 6.1 (2017); Bell, T. (2016). *The Biggest Aluminum Producers 2014* The Balance https://www.thebalance.com/the-10-biggest-aluminium-producers-2014-2339724 (2014) (last accessed on 15 July 2017).
[1372] Australian Anti-Dumping Commission, *Aluminium Extrusions from China*, REP 248, p. 79 (13 July 2015).
[1373] Taube, M. (2017). *Analysis of Market Distortions in the Chinese Non-Ferrous Metals Industry*, Think!Desk, 24 April 2017, p.51.
[1374] United States International Trade Commission (USITC); *Aluminium: Competitive conditions affecting the US industry*, p. 222. Regarding the status of private companies in the aluminium sector in China, see Wiley Rein LLP (2017): *China's Broken Promises: Why it is not a Market Economy*, p. 43 and the relevant footnote (fn. 187) referred to therein.
[1375] Chialco Articles of Association: Article 113.

Raw materials

China had in place a set of export-related measures, including export duties, export quotas, export performance requirements and minimum export price requirements on bauxite (the mined ore source for aluminium and a key input in aluminium production). The WTO Dispute Settlement Body found that these measures were inconsistent with WTO rules.[1376] While China has since removed these measures, they influenced the Chinese aluminium sector over a considerable period of time and contributed to the current configuration of this industry. China has also had in place other export restrictive measures on bauxite such as a non-automatic export licensing arrangement.[1377]

In this respect, the European Commission has found, in different investigations, that raw material prices in the aluminium sector are the result of different types of government's intervention.[1378]

VAT rebates policy

The government implements VAT policies that discourage exports of primary aluminium and its inputs, and rather aim to promote exports of higher added value aluminium products. It does so by granting full or partial VAT rebates on downstream aluminium products, but not on primary aluminium and aluminium scrap.[1379] The result is a depression of prices of primary aluminium in the Chinese domestic market, thereby providing a significant cost advantage for Chinese producers of processed aluminium products.[1380]

This policy has been confirmed by the European Commission in several investigations into aluminium products from China, as well as by other investigating authorities.[1381]

[1376] WT/DS398: Report of the Panel: China – Measures related to the exportation of various raw materials; 5 July 2011.
[1377] OECD, *Trade in raw materials*: http://www.compareyourcountry.org/trade-in-raw-materials?cr=oecd&lg=en&page=0 (accessed on 10 July 2017).
[1378] Commission Regulation (EU) No 404/2010 imposing a provisional anti-dumping duty on imports of certain aluminium wheels originating in China; 11.5.2010, OJ L 117, p.64; Council Implementing Regulation (EU) No 1039/2012 of 29 October 2012 imposing a definitive anti-dumping duty and collecting definitively the provisional duty imposed on imports of aluminium radiators originating in China, 9.11.2012; OJ L 310, p.1.
[1379] USITC. *Aluminium: Competitive conditions affecting the US industry*, pp 254-256 (2017); Zou, S. (2016) 2017 PREVIEW: *Will China's aluminium imports, exports see a repeat of the surges of 2016?* Metal Bulletin https://www.metalbulletin.com/Article/3646560/2017-PREVIEW-Will-Chinas-aluminium-imports-exports-see-a-repeat-of-the-surges-of-2016.html (accessed on 10 July 2017); Platts. (2014). *China unlikely to cut 15% export tax on primary aluminum: sources*. https://www.platts.com/latest-news/metals/sydney/china-unlikely-to-cut-15-export-tax-on-primary-27916222 (accessed on 10 July 2017);
[1380] Council Implementing Regulation (EU) No 1039/2012 of 29 October 2012 imposing a definitive anti-dumping duty and collecting definitively the provisional duty imposed on imports of aluminium radiators originating in China, 9.11.2012; OJ L 310, p.1, para. 21.
[1381] Commission Regulation (EU) No 404/2010 imposing a provisional anti-dumping duty on imports of certain aluminium wheels originating in China; 11.5.2010, OJ L 117, p.64; Commission Regulation (EU) No 833/2012 of 17 September 2012 imposing a provisional anti-dumping duty on imports of certain aluminium foils in rolls originating in China, 18.9.2012, OJ L 251, p.29; *Australia:* REP 181, p.34, REP 248, pp.77-78, REP 263, pp.81-83; *Canada*: CBSA: Statement of Reasons concerning the final determination with respect to the dumping and

Export taxes on unwrought aluminium

China has also had in place an export tax of 15% on unwrought aluminium (alloyed and non-alloyed) and aluminium scrap.[1382] It has been argued that the reason for this export tax is to shift exports towards high-added value products. Environmental concerns have also been invoked as a reason for adopting these policies.[1383]

By reducing the volume exported and increasing artificially the level of domestic supply, the domestic price of primary aluminium, which represents a key cost-driver for aluminium processed products, is kept artificially lower than would otherwise be the case in the absence of these policies.

Energy and electricity

Electricity is one of the main cost drivers in aluminium production.[1384] Through the central government's and local authorities' involvement in the energy sector, aluminium producers benefit from reduced electricity prices (see Chapter 10). In some of these cases, this intervention has, allegedly, been critical in order to keep the plant producing. Otherwise it would have been necessary to shut down production and lay off thousands of workers. [1385]

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subsidizing of Certain Aluminium Extrusions originating in or exported from China, 3 March 2009., pp. 89-92; *USA*: Office of the United States Trade Representative (2017.), National Trade Estimate Report on Foreign Trade Barriers, p. 83,

[1382] Commission Regulation (EU) No 404/2010 imposing a provisional anti-dumping duty on imports of certain aluminium wheels originating in China; 11.5.2010, OJ L 117, p.64; OECD. (2014). *Export Restrictions on Industrial Raw Materials*: http://qdd.oecd.org/data/ExportRestrictions_IndustrialRawMaterials/CHN..7601+760110+760120+7602+760200+7604+760410+760429..2014; (2014) (last accessed on 10 July 2017). WTO. (2016). China's Trade Policy Review, p. 73.

[1383] CBSA: *Statement of Reasons concerning the final determination with respect to the dumping and subsidizing of Certain Aluminium Extrusions originating in or exported from China*, 3 March 2009, p.91; Platts. (2014) *China unlikely to cut 15% export tax on primary aluminum: sources*. https://www.platts.com/latest-news/metals/sydney/china-unlikely-to-cut-15-export-tax-on-primary-27916222 (last accessed on July 2017).

[1384] It is estimated that the energy costs are in the range of 20% to over 40% of the total costs of producing primary aluminium. See e.g. The Aluminium Association: http://www.aluminum.org/industries/production/primary-production; (last accessed 17 October 2017); https://rusal.ru/en/aluminium/energetics/ (last accessed 17 October 2017); https://agmetalminer.com/2015/11/24/power-costs-the-production-primary-aluminum/ (last accessed 17 October 2017); Communication from the Commission to the European Parliament, the European Council and the Council: *Towards a robust trade policy for the EU in the interest of jobs and growth* (2016), p.2.

[1385] USITC. *Aluminium: Competitive conditions affecting the US industry*, pp 256-257; Capital Trade Incorporated: *An Assessment of China's Subsidies to Strategic and Heavyweight Industries,* submitted to the U.S.-China Economic and Security Review Commission: https://www.uscc.gov/sites/default/files/Research/AnAssessmentofChina'sSubsidiestoStrategicandHeavyweightIndustries.pdf; Metal Bulletin. (2012). *China aluminium smelters offered extra subsidies to keep producing.* https://www.metalbulletin.com/Article/3041167/China-aluminium-smelters-offered-extra-subsidies-to-keep-producing.html (accessed on 19 December 2017).

An example of this situation was described as follows:

> *The recent and dramatic fall in the Chinese aluminium price to its current level of around CNY 10 300 (USD 1 612) on the SHFE has seen significant pressure come to bear on Chinese smelters. Official notifications of closures totalled around 2Mt in the September Quarter, but subsequent to those announcements there has been a flurry of local government subsidies to help maintain production.*
>
> *A perfect illustration of the market response, albeit perhaps with overtones of economic coercion, was the October announcement by Chalco that it was fully shutting down production at its 540ktpa Lanzhou Liancheng smelter in Gansu province. The local government objected to the plan for closure and rapidly provided a significant subsidy on power—reported as being just under 30% of the power price—to maintain operations. The provision of the subsidy avoided the immediate closure of an industry in the province, and maintained the employment of an estimated 2 600 people at the site.*
>
> *In situations like this, the local government will often offer subsidies to otherwise uneconomic smelters to allay social concerns of smelter workers losing jobs. As a result, the Chinese aluminium industry falls into a vicious cycle—the more local government subsidies that are offered, the more capacity stays in the market exacerbating the surplus and the lower the aluminium price will drop, at which point the local government must again offer higher subsidies.*[1386]

In addition, as developed in further detail in section 10.2.1.5, there is evidence of aluminium smelters benefitting from distorted energy costs through the use of captive power plants.

The Australian Anti-Dumping Commission further described different examples of this practice in a recent investigation on imports of *Aluminium Road Wheels* from China.[1387]

With regard to electricity, China has had in place a system whereby it has provided cheaper electricity to electrolytic aluminium producers (See Section 10.2.1.2).[1388]

[1386] AME Research. (2015). *Smelting Subsidies Grow as Aluminium Price Falls*. http://www.amegroup.com/Website/FeatureArticleDetail.aspx?faId=156 (accessed on 15 July 2017).

[1387] Australia Anti-Dumping Commission, *Aluminium Road Wheels from China*; REP 378, May 2017, p.94; see also: http://www.theaustralian.com.au/business/economics/chinese-exports-surge-amid-overcapacity-at-home/news-story/1f73d72eb6890b33ca8261991e54d39b; WSJ: https://www.wsj.com/articles/chinese-exports-surge-amid-overcapacity-at-home-1462746980 (accessed on 19 December 2017).

[1388] Notice of State Development Planning Commission and Ministry of Finance on Lower the Electricity Price and Exemption of Government Funds for Aluminium and Nonferrous Metals Enterprises (repealed in 2011 by Order No. 10 of NDRC (see http://www.gov.cn/gongbao/content/2012/content_2049999.htm). For current policy, see the Notice on the Implementation of a Multiple-Tier-Pricing of Electricity Used by Electrolytic Aluminium Enterprises (关于电解铝企业用电实行阶梯电价政策的通知).

Stockpiling policy

The government has purchased primary aluminium on several occasions during the past few years via the SRB (See Section 12.6.1), with the purpose of stabilizing the price of aluminium products and mitigating excessive capacity. [1389] These purchases were made at above-market prices and had a direct impact on the market, resulting in an increase in prices:

- In January 2009, the government purchased 300 000 tonnes of electrolytic aluminium at the price of RMB 12 350 per tonne, 10% higher than the market price;
- In February 2009, the government purchased 300 000 tonnes of aluminium at the price of RMB 12 300 per tonne; 10% higher than the market price;
- In November 2012, the government purchased 160 000 tonnes of electrolytic aluminium at the price of RMB 15 740 per tonne, more than 10% higher than the market price;
- In March 2013, the government purchased 300 000 tonnes of aluminium at the price of RMB 15 137 per tonne, 4% higher than the market price. [1390]

In addition to these purchases, there are indications that the China Nonferrous Metals Industry Association proposed to the NDRC to purchase 900 000 tonnes of aluminium in late 2015, [1391] and other reports suggest involvement of the SRB in further stockpiling practices in 2016. [1392]

Note that China does not publish the date, the prices and the quantities of aluminium it has stockpiled. Hence the above list is likely to be incomplete.

Provisions suggesting the continuation of the stockpiling policy are included in the 13th FYP for Non-Ferrous Metals (see Section 15.1.1).

SHFE

Several EU investigations have analysed the role of the SHFE and its influence on the domestic market for aluminium (See section 12.7). In anti-dumping investigations, the European Commission consistently concluded that the government interferes with the price

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[1389] Australia Anti-Dumping Commission, *Certain Aluminium Extrusions from China*; REP 148, 15 April 2010; Commission Regulation (EU) No 404/2010 imposing a provisional anti-dumping duty on imports of certain aluminium wheels originating in China; 11.5.2010, OJ L 117, p.64; Council Implementing Regulation (EU) No 1039/2012 of 29 October 2012 imposing a definitive anti-dumping duty and collecting definitively the provisional duty imposed on imports of aluminium radiators originating in China, 9.11.2012; OJ L 310, p.1, rec. 22; Commission Regulation (EU) No 833/2012 of 17 September 2012 imposing a provisional anti-dumping duty on imports of certain aluminium foils in rolls originating in China, 18.9.2012, OJ L 251, p.29, para. 37.
[1390] Ihuiye. (2016). 收储能"解救"铝价吗？从铝行业历年收储来看 Available at: http://news.ihuiye.cn/focus/news/2016011313825.html (last accessed 17 July 2017).
[1391] CNStock. (2015). 镍铝收储传闻再起 有色金属板块短期迎利好 available at: http://news.cnstock.com/industry,rdjj-201511-3634843.htm (last accessed 17 July 2017).
[1392] Kang, K. (2015). *Spot Analysis: China's aluminium stockpiling moves could relate to coal.* Metal Bulletin. https://www.metalbulletin.com/Article/3514625/SPOT-ANALYSIS-Chinas-aluminium-stockpiling-moves-could-relate-to-coal.html; Liu, K. (2016) Stockpiling – Comparing 2010 with 2016. AZ China. http://az-china.com/archives/7433 (last accessed July 2017).

setting mechanisms in the SFHE, and thus creates a distortion in the primary aluminium and downstream markets by depressing prices.[1393] In the same vein, the Australian anti-dumping investigating authority has determined that the aluminium prices paid in the SHFE did not '*reasonably reflect competitive market costs'* and that, aluminium being a globally traded commodity product, the nature and correlation of prices identified between the SFHE and the LME '*was not consistent with the forces of supply and demand'*.[1394]

15.4. STATE SUPPORT MEASURES

As confirmed by different investigating authorities, Chinese aluminium producers have consistently benefitted from a variety of State support measures from the government and other public bodies. In this respect, a study established that the main recipients of these measures are primarily SOEs.[1395]

Some examples are provided below:

The CBSA established that Chinese producers of certain aluminium extrusions had benefited from numerous subsidies.[1396] Those subsidy schemes include, inter alia:

- Primary Aluminium Provided by Government at Less Than Fair Market Value;
- Preferential Loans;
- Equity Infusions / Debt-to-Equity Swaps;
- Preferential Income Tax Programmes;
- Preferential Tax Policies for Enterprises with Foreign Investment Established in the Coastal Economic Areas and in the Economic and Technological Development Zones;
- Research and Development Assistance Grants;
- Superstar Enterprise Grants;
- Matching Funds for International Market Developments for SMEs;
- 'Famous Brands of China';
- Export Brand Development Fund;
- Preferential Tax Policies for Foreign Invested Enterprises;

[1393] Commission Regulation (EU) No 833/2012 of 17 September 2012 imposing a provisional anti-dumping duty on imports of certain aluminium foils in rolls originating in the People's Republic of China, OJ L 251, 18.9.2012, p.29; Council Implementing Regulation (EU) No 1039/2012 of 29 October 2012 imposing a definitive anti-dumping duty and collecting definitively the provisional duty imposed on imports of aluminium radiators originating in the People's Republic of China, OJ L 310, 9.11.2012, p.1; Commission Regulation (EU) No 404/2010 of 10 May 2010 imposing a provisional anti-dumping duty on imports of certain aluminium wheels originating in the People's Republic of China; OJ L 117, 11.5.2010, p. 64.

[1394] Australian Customs and Border Protection Service: *Certain aluminium extrusions exported to Australia from the People's Republic of China*, REP 148; 15.4.2010, p. 35.

[1395] Taube, M. (2017). *Analysis of Market Distortions in the Chinese Non-Ferrous Metals Industry*, Think!Desk, 24 April 2017, pp. 61-62.

[1396] CBSA: *Statement of Reasons concerning the final determination with respect to the dumping and subsidizing of Certain Aluminium Extrusions originating in or exported from China*, 3 March 2009.

- Preferential Tax Policies for Foreign Invested Export Enterprises;
- Local Income Tax Exemption and/or Reduction;
- Exemption of Tariff and Import VAT for Imported Technologies and Equipment;
- Patent Award of Guangdong Province;
- Training Program for Rural Surplus Labour Force Transfer Employment;
- Reduction in Land Use Fees;
- Provincial Scientific Development Plan Fund;

Similarly, the Australian authorities established that Chinese producers of aluminium extrusions had received a number of subsidies. These include, inter alia, the following categories:[1397]

- Aluminium provided at less than adequate remuneration
- Grants
- Preferential Tax Policies
- Tariff and VAT Exemptions on imported materials and equipment

In addition, in August 2017, the US Department of Commerce ('USDOC') issued an *Affirmative Preliminary Countervailing Duty Determination on Aluminum Foil from the People's Republic of China.*[1398]In the investigation, the USDOC concluded, in a preliminary determination, that Chinese aluminium foil producers had benefitted from a wide range of subsidies, falling inter alia, amongst the following categories:

- Policy loans
- Preferential loans for SOEs
- Export loans from Chinese State-Owned Banks
- Export Buyers' Credit
- Income Taxes Reductions/Deductions/Concessions
- Tax Exemptions
- Provision of Electricity and Steam Coal at LTAR
- Grants

Similarly, a report by the United States International Trade Commission referring to US investigations and market intelligence indicates that subsidies, such as provision of inputs at LTAR, have been provided by SOEs in the aluminium sector.[1399]

[1397] Australian Anti-Dumping Commission: *Review of Anti-Dumping Measures on Certain Aluminium Extrusions exported from China*, REP 248, 13 July 2015. For a full list of the subsidy schemes found countervailable, see pages 87-88.
[1398] United States Department of Commerce, 7 August 2017, *Decision Memorandum for the Preliminary Affirmative Determination: Countervailing Duty Investigation of Certain Aluminum Foil from the People's Republic of China*, C-570-054.
[1399] USITC. *Aluminium: Competitive conditions affecting the US industry*, p. 262-263.

This section has shown that the aluminium sector in China is characterised by the existence of a large number of State support measures granted to producers. Such intervention by the State creates a distortion in the market, granting an artificial advantage to Chinese producers, as explained in other chapters of this Report.

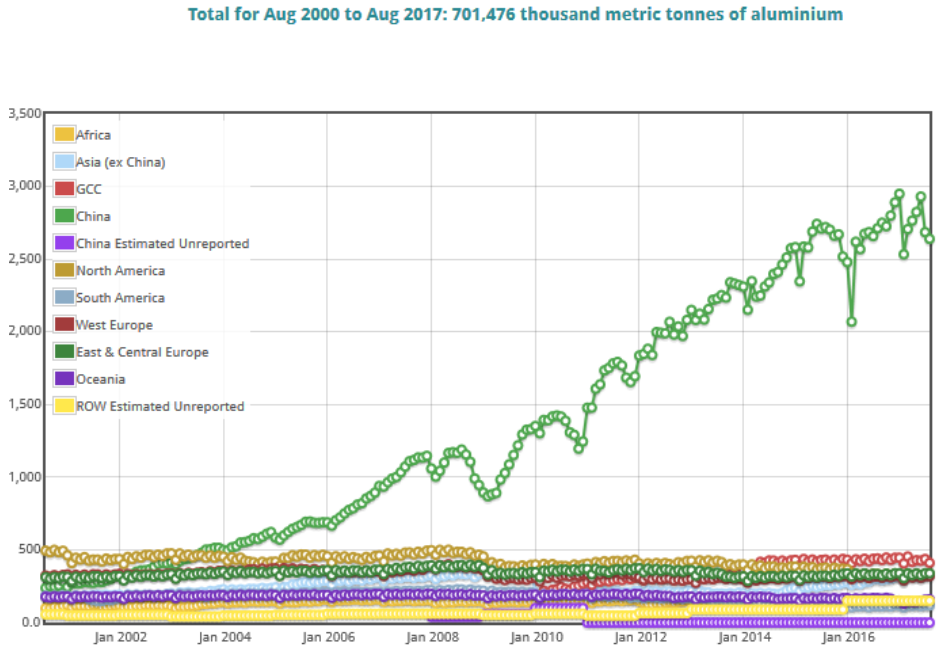
15.5. OVERCAPACITY

15.5.1. OVERVIEW

Since the early 2000's, and particularly in the last decade, the Chinese aluminium industry has experienced massive growth, both in alumina and primary aluminium production. In the past few years, China has accounted for the vast majority of the production capacity increase in the aluminium sector worldwide.[1400]

The two graphs displayed below clearly illustrate this trend:

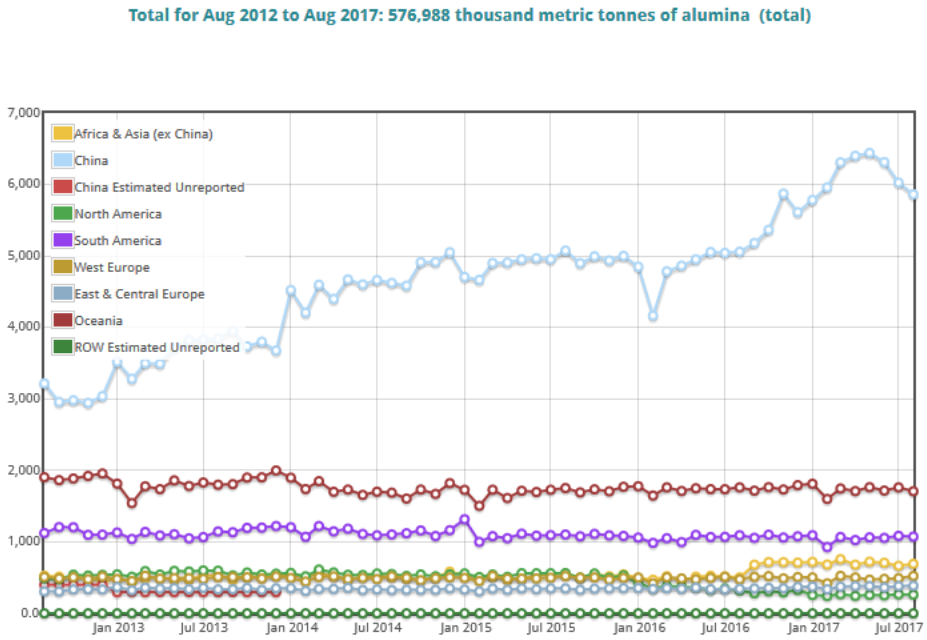
Figure 29: Production of primary aluminium



Source: International Aluminium Institute website: http://www.world-aluminium.org/statistics/#linegraph (last accessed September 2017).

[1400] European Union Chamber of Commerce in China. (2016): *Overcapacity in China: An Impediment to the Party's Reform Agenda*, p.19.

Figure 30: Alumina production



Source: International Aluminium Institute website: http://www.world-aluminium.org/statistics/#linegraph (last accessed September 2017).

This upwards trend can be partially explained by an increase in the domestic and global demand, which attracted investment in the sector. At the same time, as explained in Sections 10.2.1.2 and 15.3, there are examples of State-owned aluminium producers benefitting from lower energy costs due to government intervention, in addition to the generally favourable access to finance for Chinese SOEs (see Chapter 6). Aluminium production is energy-intensive[1401] and unlike other major aluminium producing countries, China does not enjoy a particular comparative advantage resulting in lower energy costs. Therefore any government action influencing such an important cost element provides an artificial advantage to Chinese aluminium producers. As a consequence, this type of government support has contributed to an increase in production capacity, which would not have otherwise occurred in the absence of such support. This has led to the existing problem of overcapacity in the sector.

15.5.2. CURRENT SITUATION AND PREVIOUS ATTEMPTS TO CURB OVERCAPACITY

As in other sectors of the Chinese economy, most notably steel (see Section 14.4), the Chinese aluminium sector is also suffering a serious problem of overcapacity. It is estimated that in 2015, the total capacity had almost doubled if compared with the year 2008. As a result of such an increase, there were 9.2 million tonnes of overcapacity in the Chinese aluminium

[1401] Communication from the Commission to the European Parliament, the European Council and the Council: *Towards a robust trade policy for the EU in the interest of jobs and growth* (2016), p.2; European Union Chamber of Commerce in China. (2016): *Overcapacity in China: An Impediment to the Party's Reform Agenda*, p. 19.

sector, increasing from 4.9 million tonnes in 2008 (i.e. an increase in overcapacity of more than 85% in seven years).[1402] Currently, China produces more than half of the world's total primary aluminium[1403] with the overcapacity problem felt across the global aluminium market.[1404]

This problem has been widely acknowledged by the government and it has made several attempts to curb it. However, the situation has only worsened in recent years due, to a large extent, to the government policies and practices described in detail above in this chapter.

Since the early 2000's the government has launched several (unsuccessful) attempts aimed at reducing overcapacity in the sector. Some of the documents guiding the most relevant attempts are referred to below:

- Several Opinions on Curbing Illegal Construction and Irrational Investment in the Electrolytic Aluminium Industry (2003);[1405]
- Circular on Accelerating the Restructuring of the Sectors with Production Capacity Redundancy (2006);[1406]
- Notice on Strengthening Work on the Elimination of Backward Production Capacity (2010);
- Notice on the Implementation of a Multiple-Tier-Pricing of Electricity Used by Electrolytic Aluminium Enterprises (2013);
- Guidelines of the State Council on Resolving the Contradiction of Serious Overcapacity (2013);[1407]
- Circular of the State Council on Publishing the Catalogue of Investment Projects subject to Government Approval (2014 Version);
- Guiding Opinion on Building Sound Market Environment, Promoting Non-Ferrous Metals Industry to Adjust Structure and to Transform and Improving Efficiency (2016).

Since the government started adopting policies to reduce overcapacity, there have been consistent concerns about the actual effectiveness of these measures, as they actually achieved the opposite result and led to increased overcapacity.[1408] The reluctance of local and

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[1402] European Union Chamber of Commerce in China. (2016): *Overcapacity in China: An Impediment to the Party's Reform Agenda.*
[1403] International Aluminium Association: http://www.world-aluminium.org/statistics/, (last accessed July 2017).
[1404] As explained in Section 14.4, overcapacity causes amongst other effects, a surge of exports, depression of aluminium prices world-wide and hence destabilising global aluminium markets. In addition, overcapacity has also been found to negatively affect profitability.
[1405] Several Opinions on Curbing Illegal Construction and Irrational Investment in the Electrolytic Aluminium Industry Guo Ban Fa [2003] No.103.
[1406] Circular on Accelerating the Restructuring of the Sectors with Production Capacity Redundancy, Guo Fa [2006] No. 11.
[1407] Guidelines of the State Council on Resolving the Contradiction of Serious Overcapacity, Guo Fa [2013] No. 41.
[1408] Sanderson, H. (2017). *Call to tackle China's soaring aluminium output,* Financial Times https://www.ft.com/content/2f255636-0b21-11e7-ac5a-903b21361b43; Dyer, G. and Lau, J. (2009). *China to cut back industrial expansion* Financial Times https://www.ft.com/content/fe0979dc-ad6e-11de-9caf-00144feabdc0

provincial authorities to comply with the government's measures that would lead inter alia, to unemployment and risk of social instability is consistently identified as one of the key factors for the consistent failure of these policies.[1409]

15.6. CHAPTER SUMMARY

There are numerous plans, directives and other documents pertaining to aluminium, issued at the national, regional and municipal level, clearly showing the high degree of intervention of the Chinese government in the aluminium sector. Through these and other instruments, the government directs and controls virtually every aspect of the development and functioning of the sector (Section 15.1). China is the largest aluminium producer in the world. Its domestic market is served significantly by large SOEs which account for a dominant share of Chinese aluminium production and production capacity. These SOEs are a primary vehicle for implementing these government policies (Section 15.2).

Beyond the plans, the government's intervention in the sector has taken the shape, inter alia, through export-related measures, including export duties, export quotas, export performance requirements and minimum export price requirements on different raw materials for aluminium. The government has also implemented VAT rebate policies and export taxes on aluminium products (e.g. primary aluminium and scrap). Moreover, key inputs such as energy and electricity are found to be influenced by different types of government intervention. Other types of government intervention leading to market distortions include the stockpiling policy through the SRB and the role of the SHFE (Section 15.3). In addition, several trade defence investigations have established that the Chinese government has consistently granted different types of State support measures to aluminium producers (Section 15.4).

The extensive intervention of the government in the aluminium sector has led to overcapacity. This is negatively affecting the performance of aluminium producers worldwide, in particular, their financial indicators, employment, etc. As in the case of steel, it remains to be seen whether the government will be able to successfully curb overcapacity in the aluminium sector (Section 15.5).

(last accessed on 17 July 2017); Taube, M. (2017). *Analysis of Market Distortions in the Chinese Non-Ferrous Metals Industry*, Think!Desk, 24 April 2017, p. 108.

[1409] AME Research. (2015). Smelting Subsidies Grow as Aluminium Price Falls, available at: http://www.amegroup.com/Website/FeatureArticleDetail.aspx?faId=156; Reuters. (2009). *China tries, again, to curb industrial overcapacity.* Available at: http://uk.reuters.com/article/idUKPEK159245 (last accessed on 17 July 2017).

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16.1. PRODUCTS CONCERNED

Chemicals which are the subject this chapter are products classified under HS Section VI, i.e. HS chapters 28 to 39, except for Chapter 30 (Pharmaceuticals), namely:

Chapter 28: Inorganic chemicals;

Chapter 29: Organic chemicals;

Chapter 31: Fertilisers;

Chapter 32: Tanning or dyeing extracts; paints; inks;

Chapter 33: Essential oils and resinoids; perfumery;

Chapter 34: Soap, washing preparations;

Chapter 35: Albuminoidal substances; modified starches;

Chapter 36: Explosives; pyrotechnic products;

Chapter 37: Photographic or cinematographic goods;

Chapter 38: Miscellaneous chemical products;

Chapter 39: Plastics and articles thereof.

Typically, chemicals are divided into basic chemicals such as inorganic chemicals, petrochemicals and fertilisers (for the bulk of these products overcapacities exist in China), speciality chemicals (e.g. dyes, paints, pesticides, additives, electronic chemicals), polymers (e.g. plastics, man-made fibres, synthetic rubber), consumer chemicals (e.g. detergents, cosmetics, fragrances), as well as new chemical materials (for which China is not self-sufficient and a net importer of many products).

16.2. THE CHINESE CHEMICALS MARKET

16.2.1. CHINA'S GLOBAL POSITION

China as a country largely dominates the 2016 top five countries producing chemicals ranking by value of sales (EUR billion):[1410]

- China: 1 331
- USA: 476
- Germany: 145
- Japan: 140
- South Korea: 113

[1410] Source: European Chemical Industry Council (CEFIC), Chemdata International 2017.

In 2016, China represented almost 40% of the world chemicals market (against for instance 15% for the EU).[1411] China also tops the 2016 ranking of world chemicals investments with an amount of EUR 99.2 billion (against e.g. EUR 21.7 billion for the EU).[1412]

16.2.2. PRODUCTION

Top Chinese chemical companies moved up the value chain. This is evident from the emergence of the synthetic materials and specialty chemicals segments, the marginal retreat of basic chemicals and the significant dip in fertilisers and pesticides companies. Companies have expanded their capacities and have often focused on products for which China used to depend on imports. China is now becoming a net exporter for more and more chemicals.[1413]

In its trade with the rest of the world, China is until now a net importer of chemicals although pretty close to a balanced trade position. In 2016, China imported USD 151.64 billion (-6.1% year-on-year) and exported USD 141.29 billion (-7.1% year-on-year) of chemicals.[1414]

According to MIIT, during the 12th FYP, China's chemical industry's production value grew by an annual average growth of 9%.[1415]

16.2.3. MAIN INDUSTRY SEGMENTS

In principle, in the Chinese market, low-end chemical products are all in oversupply, while large quantities of high-end chemical specialties have to be imported. Along with the BRI initiative, local players aim at exporting more products which are plagued by overcapacity, e.g. chemical fertilisers, pesticides, methanol, tyres, etc.

Petrochemicals represent the largest individual sector in the Chinese chemicals market. Its value in 2015 was around EUR 122 billion. For the period 2015-2020, this segment is forecast to grow annually by almost 6%. Petrochemicals are one of the priority sectors in the 13th FYP, with a particular focus on refining, the production of olefins, aromatic hydrocarbons and organic chemicals. In that respect, China is also striving to boost the production of higher end products, such as commodity polymers, engineered polymers, and synthetic rubbers.[1416]

Fertilisers form the second largest sector in the Chinese chemicals market today. The Chinese fertiliser market was worth around EUR 107 billion in 2015, accounting for almost one third

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[1411] Ibid.
[1412] Ibid.
[1413] Pflug, K. (2016). *Market Outlook: Thriving in China´s competitive chemical market*. ICIS Chemical Business, 26 May 2016. www.icis.com/resources/news/2016/05/26/10002360/market-outlook-thriving-in-china-s-competitive-chemical-market/ (accessed on 24 August 2017).
[1414] Source: China Petroleum & Chemical Industry Federation (CPCIF); MIIT.
[1415] Petrochemical and Chemical Industry Development Plan (2016-2020). MIIT, 18 October 2016.
[1416] Think Act. (2016). *Keep the Dragon Flying*. Roland Berger. https://www.rolandberger.com/publications/publication_pdf/roland_berger_tab_chemicals_china_final_071016.pdf (accessed on 9 August 2017).

of global fertiliser use. In 2015, China's share of world nitrogen urea production was 40%. During the same year, China's share of world urea exports was 29%. China's share of world phosphates production was 50% and China's share of world phosphates exports was 30%. China has quickly become the world's leading producer, consumer and exporter of nitrogen and phosphate products. Overcapacity in this segment can be directly traced-back to industrial policy priorities of the past FYPs. There is now a significant supply surplus in fertilisers leading to exports and idle capacity. While no more expansion targets are envisaged for the fertiliser segment in the 13th FYP, it speaks nevertheless of '*upgrading of traditional industry segments*' (see also Section III.2 of the 13th FYP). [1417]

16.2.4. GEOGRAPHICAL DISTRIBUTION OF THE CHEMICAL INDUSTRY

The Chinese chemical sector is of considerable size and accounts for no less than ca. 25 000 chemical companies. [1418] While much of China's industrial base is scattered across the country, chemical plants are found predominantly in Central and Eastern provinces. The industry's main producing provinces are Shandong, Jiangsu, Guangdong, Zhejiang and Liaoning. Their combined output exceeds 50% of the country's total.[1419]

China has built an array of dedicated chemical parks around user industries, often in close proximity to feedstock supply, to fit the State policy of reducing dependency on imports.[1420] Chemical industry parks were generally set up as satellite sites at Economic and Technological Development Zones or as separate, independently operated industrial parks. The first chemical parks were created in the early 2000s. The Shanghai (Caojing), Nanjing Chemicals, Daya Bay Economic-Technological Development Area, Ningbo Petrochemical Economic-Technological Development Area, and PetroChina (Qinzhou) Industry Park parks are national level parks, while many others are managed at the provincial level. Most chemical industry parks are situated in the eastern coastal regions.

Table 15: Top 20 Chemical Parks in China (2017)

Chemical Park	Location
Shanghai Chemical Industry Park (SCIP)	Shanghai
Daya Bay Economic-Technological Development Area	Huizhou, Guangdong
Ningbo Petrochemical Economic-Technological Development Area	Ningbo, Zhejiang
Nanjing Chemical Industry Park (NCIP)	Nanjing, Jiangsu
Ningbo Daxie Chemical Industry Park	Ningbo, Zhejiang

[1417] Hatfield O. (2016). *The Chinese fertilizer industry. Current situation and outlook.* Integer Research Ltd, September 2016.
[1418] EUCCC. (2016). *Overcapacity in China: An Impediment to the Party's Reform Agenda.*
[1419] See Flanders Investment & Trade. (2015). *China's Petrochemical and Chemical Industry*. Guangzhou, November 2015.
[1420] Roland Berger. (2015). *Chemicals 2035 – Gearing Up For Growth.* https://www.rolandberger.com/publications/publication_pdf/roland_berger_tab_chemicals_2035_20150521.pdf (accessed on 9 August 2017).

Yangzi River Int'l Chemical Industry Park	Zhangjiagang, Jiangsu
Taixing Economic Development Area	Taixing, Jiangsu
Yangzhou Chemical Industry Park	Yangzhou, Jiangsu
Qilu Chemical Industry Park	Zibo, Shandong
Dongying Harbor Economic Development Area	Dongying, Shandong
China Chemical New Material (Jiaxing) Park	Jiaxing, Zhejiang
Cangzhou Lingang Economic-Technological Development Area	Cangzhou, Hebei
Quanzhou Petrochemical Industry Park	Quanzhou, Fujian
Changshou Economic-Technological Development Area	Chongqing
Maoming High-New Tech Industrial Development Area	Maoming, Guangdong
Wuhan Chemical Industry Park	Wuhan, Hubei
Jiangsu High-Tech Fluro-Chemical Industry Park	Changshu, Jiangsu
PetroChina (Qinzhou) Industry Park	Qinzhou, Guangxi
Jilin Circular Economy Demonstration Park	Jilin
Ji'ning New Material Industry Park	Ji'ning, Shandong

Source: China Petroleum and Chemical Industry Federation ('CPCIF').

The State continues its policy of pushing for a streamlining of the geographical structure of the industry, predominantly into existing or new parks, in more favourable areas than in the past, often due to continuous considerations regarding infrastructure, environmental issues or access to inputs. The drive to create even more petrochemical and chemical conglomerates is visible in the planning documents of provinces (see Section 16.3.4), not least because a higher number of localised companies translates itself notably into higher fiscal income and lower unemployment.

16.2.5. STATE-OWNED ENTERPRISES

The table below presents the top twenty chemical companies in China. The largest chemical companies (by 2015 sales revenue) in China are SOEs, including eight of the first ten largest chemical enterprises.[1421]

According to national statistics, SOEs in the chemical sector represent 52% of the total assets of chemical companies.[1422]

SOEs, in particular large central ones, have traditionally played a dominant role in China's petrochemical industry due to their oligopoly position in upstream/feedstock, easy access to government-allocated resources (funds, loans, land etc.) and strong influence in government decision-making.[1423]

[1421] China Chemical Enterprise Management Association (CCEMA). (2016). *List of Top 500 Chinese Chemical Companies in 2016*. China Petroleum & Chemical Industry Federation (CPCIF). (2016). 2016 中国化工企业 500 强发布 29 June 2016. http://www.cpcia.org.cn/html/13/20166/155709.html (accessed on 4 August 2017).
[1422] Data for 2015 on the basis of the China Statistical Yearbook 2016, National Bureau of Statistics of China.
[1423] AT Kearney. (2012). *China's Chemical Industry: Flying Blind?* September 2012.https://www.atkearney.com/documents/10192/647356/Chinas-Chemical-Industry---Flying-Blind.pdf/d830dd95-dcbf-46a6-afc6-8fcab1fc9204 (accessed on 9 August 2017).

Table 16: The 20 largest Chinese chemical companies

No.	Company name	Ownership
1.	ChemChina	SOE
2.	Henan Energy Chemical Industry Group Co. Ltd.	SOE
3.	China PingMei Shenma Energy Chemical Co. Ltd.	SOE
4.	Tianjin Bohai Chemical Industry Group. Co. Ltd.	SOE
5.	Hubei Yihua Group Co. Ltd.	SOE
6.	Yuntianhua Group. Co. Ltd.	SOE
7.	Shandong Dongming Petrochemical Group Co.	private
8.	Shandong Jingbo Holding Co. Ltd.	private
9.	China National Chemical Engineering Co.	SOE
10.	Shanghai Huayi Group	SOE
11.	Wengfu (Group) Co. Ltd.	SOE
12.	Wanda Holding Co. Ltd.	private
13.	Shanxi Yangmei Chemical Industry Investment Co. Ltd.	SOE
14.	Lihuayi Group Co. Ltd.	private
15.	Jiangying Chengxing Industy Group Co. Ltd.	private
16.	Jiangsu Sanfanggang Group. Co. Ltd.	private
17.	Shandong Haike Chemical Industry Group Co. Ltd.	private
18.	Hengli Petrochemical (Dalian) Co. Ltd.	private
19.	Sinochem International (Holding) Co. Ltd.	SOE
20.	Shandong Huatai Group Co. Ltd.	private

Source: China Petroleum and Chemical Industry Federation ('CPCIF').

Government-owned Sinochem is a primary example of a large-scale diversified enterprise. It has a vast range of activities spanning energy, agriculture, chemicals, real estate and financial services. It is also the biggest fertiliser supplier and distributor in the chemical business and controls a well-developed chemical logistics infrastructure, including tankers and shipping services. It is also China's leading pesticide company.[1424]

16.2.6. OVERCAPACITY

Analysts agree that the issue of overcapacity is particularly relevant in the chemical industry.

For example, with regard to nylon-6, there was only a 63% capacity utilisation rate in 2015 (the difference between capacity and production volume amounted to 122 000 tonnes). The utilisation rate of caprolactam was 70% and there was a difference of 109 000 tonnes between capacity and production volume, with the utilisation rate projected to fall by 13% between

[1424] KPMG. (2013). *China's chemical industry: The emergence of local champions*. October 2013. https://assets.kpmg.com/content/dam/kpmg/pdf/2013/10/China-Chemical-Industry-201310.pdf (accessed on 9 August 2017).

2015 and 2017. The oversupply of chlorine in 2015 amounted to 300 000 tonnes and is projected to increase to 1.1 million tonnes in 2017.[1425]

For 1,4-butanediol (BDO) and for acetic acid the current capacity utilisation is well below 50%. In fertilisers, China has by far the largest urea production capacity in the world, with an estimated capacity production volume of 110 million tonnes in 2015 (representing around 45% of the total world capacity). In comparison, the 2015 domestic consumption of urea in China was just 61 million tonnes. In the case of melamine (a downstream product of urea), China's production capacity vastly exceeds domestic demand. Indeed, according to 2015 figures, it could supply the entire world, and could fill five times the European Union's demand.[1426]

Below is an overview of the situation of China's overcapacity in petrochemicals/chemical industry covering the period prior to 2015.

Table 17: Overcapacity in China per chemical product

Subsector	2012 Utilisation Rate (UR)	2013 UR	2014 UR	Trend of change
PTA	84.3%	68.6%	61%	Deteriorating
SBR	80%	73%	64%	Deteriorating
cis-BR	63%	52%	48%	Deteriorating
MAP	80.5%	66.7%	65.8%	Deteriorating
Urea	85%	83.1%	81.5%	Deteriorating
Soda Ash	83%	77.2%	81.4%	Deteriorating
DAP	78.9%	79.2%	79.2%	Unchanged
Calcium carbide	53.8%	60.7%	62.6%	Improved slightly
PVC	56.3%	61.8%	68%	Improved slightly
Methanol	60.2%	59.5%	64%	Improved slightly
Acetic acid	50-60%	50-60%	70.2%	Improved slightly
Caustic soda	72.2%	74.1%	81%	Improved
n-Butanol	81%	71%	72%	Deteriorating
2-Ethyl hexanol	73%	77%	76%	Deteriorating
Acrylic acid	81%	81%	66%	Deteriorating
Butyl acrylate	92%	82%	66%	Deteriorating

(Source: China Petroleum & Chemical Industry Federation, China Chemical Industry News)

Source: EU Chamber of Commerce in China. (2016). *Overcapacity in China: An Impediment to the Party's Reform Agenda*, p. 25.

[1425] Think Act. (2016). *Keep the Dragon Flying*. Roland Berger. https://www.rolandberger.com/publications/publication_pdf/roland_berger_tab_chemicals_china_final_071016.pdf (accessed on 9 August 2017).
[1426] *Fertecon Urea Outlook 2015/04*, cited by Fertilizers Europe.

EUCCC identifies a number of drivers for overcapacity in China's chemical industry, namely:

- China's desire for self-sufficiency;
- Local governments that, with the exception of large-scale petrochemical and coal chemical projects, can support the industry through lower electricity prices, rail freight, and tax incentives in order to stimulate upstream and/or downstream economic activity;
- Local governments protecting outdated plants and enabling them to expand the production scale in order to avoid being shut down.[1427]

All these elements are State-related or driven, and demonstrate to which extent the government in China has so far steered markets into imbalances, of which the current overcapacity problem is one of the effects.

16.3. REGULATORY FRAMEWORK

16.3.1. 13TH FYP FOR THE PETROCHEMICAL AND CHEMICAL INDUSTRY

The most comprehensive and detailed policy document concerning the Chinese chemical sector is the 13th FYP for the Petrochemical and Chemical Industry (2016-2020) (hereafter 'the Plan'). It was issued on 18 October 2016 by MIIT. Its purpose is to guide the petrochemical and chemical industry's development for the 2016 to 2020 period, in line with the provisions of the central 13th FYP and, especially, the long-term vision of the Made in China 2025 strategy.

The Plan not only sets development objectives and gives instructions on production targets by industry segments, but also imposes government control over production capacity, and over corporate decisions.

Achievement of past targets

First of all, the document gives an account of the application of the previous 12th FYP for the Chemical Industry. Among others, it outlines the shortcomings persisting in the sector. The government acknowledges that the industry still does not fulfil the State's vision of how the sector and the market should look. Indeed:

> *There are production overcapacities as regards all traditional products. Production overcapacities are particularly significant in calcium carbide, caustic soda, PVC, phosphate fertilisers, nitrogen fertilisers and other key sectors. Bulk basic materials such as ethylene, p-xylene and ethylene glycol as well as new chemical materials, high-end special-use chemical products have a low domestic self-sufficiency rate. Engineering plastics, high-end polyolefin plastics, special*

[1427] EUCCC. (2016). *Overcapacity in China: An Impediment to the Party's Reform Agenda*. p. 26.

rubber, electronic chemicals and other high-end products still rely to a large extent on imports.[1428]

The Plan also emphasizes that much remains to be done to achieve the envisaged sector's corporate structure, instead of letting the latter be shaped by market forces:

The industry model lacks rationality. Petrochemical and chemical enterprises are numerous, of a small size and production capacity is scattered. […] At the same time, the problem of chemical industry parks being 'numerous and scattered' has become relatively prominent. The level of planning, construction and management of some parks is relatively poor, supporting infrastructures are not complete and there are potential hazards as regards safety and environment.[1429]

General principles

In terms of general principles laid out in the main body of the document, one of the Plan's guiding thoughts is to revamp in a top-down manner the sector's vocation and structure by: '*focussing on the transformation and improvement of traditional industries*' [1430] and '*speed[ing] up and foster[ing] chemical industry new materials*',[1431] as well as '*[…] focus[ing] on ensuring the breakthrough of a number of core and key generic technologies such as smart manufacturing and large-sized sets of equipment*'.[1432] At the same time, the new production is to meet appropriate demand, upon which the government also aims to expand its influence: '*focus on responding to the end-consumption demand; speed up and foster new product markets*' [1433] and '*explore consumption segments using traditional products so as to expand the traditional consumption volume.'*[1434] The State aims at achieving these goals by directly intervening at various levels into the corporate structure. Among others, it seeks to: *'create a number of well-known brands with a relatively strong international influence power'*[1435] and *'ensure the emergence of a number of large-sized enterprise groups with international competitiveness, of world-class chemical industry parks, and new types of industrialisation demonstration bases focussed on petrochemical and chemical industries.*' [1436] In that framework, it '*encourages and supports enterprises to proceed to mergers and restructurings*'.[1437]

The Chinese state's ambitions are of a global scale as it requests its administrative and intertwined corporate structures to:

[1428] 13th FYP for the Petrochemical and Chemical Industry, Section I.2.1.
[1429] Ibid., Section I.2.4.
[1430] Ibid., Section II.1.
[1431] Ibid.
[1432] Ibid., Section II.2.1.
[1433] Ibid., Section III.1.
[1434] Ibid., Section III.2.
[1435] Ibid., Section II.1.
[1436] Ibid., Section II.3.2.
[1437] Ibid., Section IV.3.

> […] *support eligible enterprises to develop overseas exploitation and cooperation in the field of energy and mineral resources, actively participate in international mergers and restructurings*, […] *speed up the building of overseas production bases and cooperation parks and form a new open industry model with outstanding imports and exports records and ensuring a linkage between the domestic and overseas sectors,* [1438] [as well as] *deeply promote the implementation of the* '*Belt and Road*' *strategy,* [and] *support enterprises to participate in the exploration and exploitation of overseas resources*.[1439]

Companies are formally charged by the State with a mission to secure new technologies in foreign markets: *'Encourage backbone enterprises to acquire production technologies of chemical new materials and high-end special use chemical products through investments, mergers and acquisitions, restructurings and other methods.'*[1440]

Quantitative development targets

Further, the Plan defines overall quantitative development targets for growth and profitability to be achieved by the sector: *'Over the 13th FYP period of time, the average annual growth of the petrochemical and chemical industries shall reach 8%, the sales profit ratio shall rise a bit and reach 4.9% in 2020*'. [1441]

Supply/demand management

Most importantly, the State imposes government control over production capacity where it considers it to be in excess: '*Strictly control the number of new enterprises increasing production capacities*',[1442] '*strictly control new capacity increases in overcapacity sectors such as urea, ammonium dihydrogen phosphate, calcium carbide, caustic soda, PVC, sodium carbonate, yellow phosphorus, etc.*', '*explore and set up law-based and market-oriented withdrawal mechanisms for obsolete production capacities*', '*fully use […] price measures, so as to foster the elimination of obsolete and poorly efficient production capacities and create a still bigger space on the market for advance production technologies'.*[1443]

The Plan also confirms the goal of rebalancing overcapacity levels through sales abroad by *'speed[ing] up the cooperation between competitive domestic production capacities with countries located along the* '*Belt and Road*', *ensure[ing] the local sale of products and conquer[ing of] new and emerging markets.'*[1444]

[1438] Ibid., Section II.2.5.
[1439] Ibid., Section III.8.
[1440] Ibid.
[1441] Ibid., Section II.3.1.
[1442] Ibid., Section IV.2.
[1443] Ibid., Section III.2.
[1444] Ibid., Section III.8.

It also attempts to extend its influence on managing supply/demand in foreign markets in various sectors by advocating, for example, to:

> *[…] As regards the tires sector, foster in priority production capacity cooperation in the main areas where natural rubber is produced such as South-East Asia or where market potential is relatively strong.*
>
> *As regards the chlor-alkali sector, strengthen production capacity cooperation in areas having both an energy competitive advantage and a regional market competitive advantage such as Indonesia, Myanmar, Kazakhstan, etc.*
>
> *As regards the nitrogen fertiliser and coal chemical sectors, in priority foster production capacity cooperation in South-East Asian and East Asian areas having both resource and market competitive advantages such as Vietnam, Indonesia, Bangladesh, etc.* [1445]

In the frame of foreign activity, the Plan requires relevant parties to '*support strong enterprises in the preparation and construction of local chemical industry parks and logistics bases.*'[1446]

Industrial structure

Through the Plan, the State also intervenes by specifically shaping the industrial layout, demanding, for example, to:

> *orderly support the construction of 7 petrochemical industry bases and their related key-projects and to speed up the transformation and upgrade of existing ethylene plants, optimise raw material structures, reach an economical size, improve the level of deep-processing, strengthen international competitiveness.*[1447]

Sub-sectors

In more detailed provisions, the State translates the above provisions into development paths for specific sub-sectors, including supply and value chain management, as well as setting of industrialization targets, which all can have a direct impact on market forces:

- For fertilisers:

> *In principle, no new synthetic ammonia facility using smokeless lump coal and natural gas as raw materials shall be built. Rely on the development of an industry competitive advantage to create new links in the industry chain, such as the carbon-chemical industry. […] As regards the phosphorus fertilisers sector, it is necessary to create new links in the industry chain such as the refined*

[1445] Ibid., Box 10.
[1446] Ibid., Section III.8.
[1447] Ibid., Section III.7.

phosphorus chemical industry, wet phosphorus acid refining and other deep processing techniques […]. Combine raw materials, market and logistics factors to optimize the chemical fertilisers industry model, and promote the concentration of production capacities towards energy production sites or cotton and grain production sites.[1448]

- For potash fertilisers*:*

Accelerate the construction of overseas […] bases in Laos and Uzbekistan, etc. By 2020, strive to ensure that overseas potash fertiliser production bases reach an output of 1.2 million tonnes, and significantly improve China's overall domestic and foreign supply security capacity as regards potash fertiliser. The natural gas chemical industry shall promote capacity cooperation in Russia, the Middle East and other areas with resource advantages.[1449]

- For chlor-alkali*:*

Eliminate all PVC production facilities using high-mercury catalyst acetylene, duly develop ethylene-dichloroethane synthetic PVC technologies and foster their application.[1450]

- For new materials*:*

Focus on sectors such as aviation and aerospace, high-end equipment, electronics and IT, new energy, automobile, rail transport, energy saving and environmental protection, healthcare as well as defence and military industry so as to: duly respond to their requirements regarding light-weight, high-strength, high-temperature resistance, stability, shock-absorption, impermeability performances, etc., [and] *improve engineering plastic industry technologies;*

Ensure a breakthrough as regards low-cost, continuous and stable as well as large-size production technologies for high-resistance carbon fibers;[1451]

Develop electronic chemicals used in integrated circuits; Focus on the development of 248 nm and 193 nm-class photoresists, […] develop LCD materials for panel displays;[1452]

Speed up the development of long carbon chain nylon, high temperature resistant nylon, PETG and high performance poly-formaldehyde modified products.[1453]

[1448] Ibid., Box 3.
[1449] Ibid., Box 10.
[1450] Ibid., Box 2.
[1451] Ibid., Section III.3.
[1452] Ibid., Box 5.

- For olefins:

> *Accelerate the promotion of key petrochemical projects construction. […] Prepare for the use of both international and domestic resources, appropriately develop methanol-to-olefins, propane dehydrogenation-to-propylene, raise the share of non-petroleum-based products in the ethylene and propylene production volume, improve the supply security capacity.*[1454]

- For arenes*:*

> *In accordance with the requirements of the National Plan for the petrochemical industry production model speed up the development of aromatic hydrocarbons production; actively promote the industrialisation of the coal-to-aromatics technology, promote the diversification of raw materials sources.*[1455]

- For ammonia/methanol:

> The Plan promotes *'sets of technology and equipment ensuring a yearly production exceeding 1 million tonnes of synthetic ammonia and synthetic methanol*'.[1456]

- For bio-materials:

> *Ensure the qualitative development of key-products such as low-cost cellulosic ethanol and its downstream product bio-ethylene and ensure a partial substitution of petroleum products.*[1457]

- In the area of smart manufacturing technologies:

> *Build more than 80 smart factories in the petrochemical and chemical industry sectors.*[1458]

Support measures

In order to achieve its goals, the Plan sets out policy support measures so as to *'ensure the connection between the tax, fiscal, financial, trade policies, etc, and the industry policy'.* In particular, it plans to *'expand the financial support to key-enterprises and key-projects, make use of existing specific funding channels (special projects, funds etc.) and keep on supporting industry upgrading and technological transformation works'.* It also envisages other accompanying instruments in the trade area, which have the potential of influencing market prices, costs and value chain structures: *'in due time, examine import and export tariffs,*

[1453] Ibid.
[1454] Ibid., Box 9.
[1455] Ibid.
[1456] Ibid., Box 1.
[1457] Ibid., Box 5.
[1458] Ibid., Box 6.

export tax refunds and the policy of processing trade applicable to petrochemical and chemical products'. Finally, market players are advised to *'ensure connections between banks and enterprises, as well as cooperation between industry and the financial sector'*,[1459] which can presuppose collusion in terms of corporate financing in the market.

Implementation

The execution of the Plan is entrusted to all administrative levels: '*Any petrochemical and chemical industry development plan of any province, autonomous region, municipality under direct management, or any central enterprise shall: duly stick to the present Plan, set out implementing plans, refine objectives, implement relevant tasks and measures, [and] their content shall be adjusted according to changes in the situation'.* The Plan envisages '*a mechanism so as to ensure the dynamic evaluation of the Plan's implementation and [so as to] ensure the dynamic monitoring of the implementation and results of the various Plan's implementation phases'*, which clearly demonstrates the commitment of the government to control the Plan's implementation at various levels. A special role is imparted to industrial associations, which should '*ensure guidance over the main tasks undertaken by enterprises to implement the Plan, to ensure the industry's self-discipline and to report any problem arising in the course of the implementation of the Plan*'.[1460]

16.3.2. STATE COUNCIL GUIDELINES ON STRUCTURE ADJUSTMENT, TRANSFORMATION, AND PROFITABILITY GROWTH OF THE PETROCHEMICAL INDUSTRY

In July 2016, that is three months before MIIT issued the 13th FYP for the Petrochemical and Chemical Industry, the General Office of the State Council released its Guidelines on Structure Adjustment, Transformation, and Profitability Growth of the Petrochemical Industry,[1461] in order to address specifically the situation of the chemical industry. The Guidelines are largely in line with the Plan that followed them, including in the manner the State undertakes efforts to manage supply patterns and sectoral structures, and to influence corporate decision-making.

The Guidelines call on, among others, to:

> *- Strive to resolve overcapacities, by strictly controlling the new capacities of sectors showing overcapacities such as urea, ammonium phosphate, calcium carbide, caustic soda, PVC, sodium carbonate, yellow phosphorus, etc. […] Any*

[1459] Ibid., Section IV.4.
[1460] Ibid., Section IV.5.
[1461] Document No. 57 of the State Council. 23 July 2016, http://www.gov.cn/zhengce/content/2016-08/03/content_5097173.htm (accessed on 9 August 2017).

new fine chemical project that is not included in the Document setting out the lay-out and plan for the petrochemical industry may not be built.[1462]

- Orderly promote the building of seven coastal petrochemical industry bases, enhance planning and building of chemical industry parks, and develop pilot projects regarding smart chemical industry parks.[1463]

- Chemical industry parks and chemical product storage projects that do not comply with requirements shall be closed and withdrawn. Enterprises producing hazardous chemical products shall be transferred to new standardised chemical industry parks (…).[1464]

- Promote enterprises' mergers and restructuring by implementing supporting tax, financial, land, staff relocation policies, lift systemic obstacles to cross-regional, cross-ownership mergers and restructuring (…), raise the sector's level of concentration and competitiveness,[1465]

- Create a number of large-sized enterprise groups having an international competitiveness.[1466]

To give effect to these goals, the Guidelines call on the ministries and local governments to expand public financial support, including by '*strengthen[ing] the support to the technological transformation of the petrochemical industry, [or] the development of high-end products*,' or by '*guid[ing] financial institutions to implement supporting and controlled credit policies*'.[1467]

Further information about which financial instruments can be mobilised in support of this industrial policy are to be found, among others, in the State Council Guidelines on Promoting Enterprise Technological Transformation of 2012, which are not sector-specific, but are applicable to the chemical industry, as per below.

[1462] Guidelines on Structure Adjustment, Transformation, and Profitability Growth of the Petrochemical Industry, Section 2.1.
[1463] Ibid., Section 2.2.
[1464] Ibid., Section 2.4.
[1465] Ibid., Section 2.6.
[1466] Ibid.
[1467] Ibid., Section 3.2.

16.3.3. STATE COUNCIL GUIDELINES ON PROMOTING ENTERPRISE TECHNOLOGICAL TRANSFORMATION

State Council Guidelines on Promoting Enterprise Technological Transformation (2012)[1468] call on Central Ministries and Provincial Governments to support the Technological Transformation of China's industries (including of the chemical sector), notably through:

> *- Expand[ing] financial support: keep on renewing and optimising the management method applicable to funds and ensure a flexible use of various types of support so as to increase the efficiency of public funds […];*
>
> *- Improv[ing] tax preferential policies: duly use existing relevant tax preferential policies to support the technological transformation of enterprises; in accordance with regulations, the VAT on standard taxpayers' purchases or VAT on self-built machinery and equipment can be deducted from the output tax amount; speed up depreciation of fixed assets as set out in the business income tax laws and regulations; the purchase and use of specific equipment for environmental protection, energy and water saving, safe production and other purposes can, to a certain extent, result in tax deductions or exemption; R&D expenses shall be aggregated and deducted from the income tax; technology transfers shall result in reduction or exemption of business income tax […];*
>
> *- Expand[ing] funding channels: strengthen the coordination and coherence of credit policy and industry policy, guide financial institutions so that they expand their financial support to the technological transformation of enterprises; regulate industry development investment funds and equity investment funds, and guide private investment so as to support the technological transformation of enterprises.*

16.3.4. PROVINCIAL PLANS

As for most industrial sectors, the above national chemical strategy is reflected, detailed and amplified at the provincial level. Key excerpts from two provincial chemical plans are presented below as examples.

[1468] Document no 44 of the General Office of the State Council. 1 September 2012. http://www.miit.gov.cn/n1146295/n1146557/n1146619/c3072814/content.html (accessed on 9 August 2017).

16.3.4.1. 13TH FYP FOR THE DEVELOPMENT OF THE CHEMICAL INDUSTRY IN JIANGSU PROVINCE

The 13th FYP for the Development of the Chemical Industry in Jiangsu Province (2016 – 2020) (hereafter 'the Plan') was adopted on 15 August 2016. It sets out a framework for implementing State targets and instruments aiming at the management of the chemical and petrochemical industry of the province, under the umbrella of the national 13th FYP for the sector as well as the Made in China 2025 policy.[1469]

In its many parts, and in accordance with the central 13th FYP for the chemical industry, the Plan reveals far-reaching government intent to manage the development of the industry, with effects on market supply and demand, as well as costs of production.

Achievement of objectives

The Plan first takes stock of the results of the previous 12th FYP. One of its outcomes was that '*Jiangsu's chemical industry has given rise to a number of new emerging industries as well as enterprises and concentration areas related to the relevant supporting sectors; the level of some products and technologies has reached an international advanced level*'. However, the Plan also notes that:

> *for many products (…) core technologies are missing, quality is not stable, the capacity to provide compliant product series and to expand the production scale is weak, and the industry remains at the mid-low end of the international industrial value chain. At the same time, due to inadequate market application development, coupled with the impact of foreign high-end products, the development space of the local emerging industry has been squeezed, industrial upgrading has come to a standstill, and corporate profitability is low.* [1470]

The Plan also states that:

> *There are still prominent problems with equipment and product homogenization and low-end orientation. […] There are serious production overcapacities for some products, a significant number of production equipment has a yearly operating ratio below 80%. But there is still a significant number of enterprises willing to invest in traditional products and traditional projects which causes a serious problem of multiple low-level constructions.*[1471]

[1469] 13th FYP for Development of the Chemical Industry in Jiangsu Province, Section III.2.2: '*In accordance with the requirements of the national plan for the petrochemical industry overall arrangement, [Jiangsu shall] meet all needs of the "Made in China 2025" strategy implementation as well as of the new and emerging industries' development*'.
[1470] 13th FYP for the Development of the Chemical Industry in Jiangsu Province, Section I.2.4.
[1471] Ibid., Section I.2.1.

It transpires through these lines that the Jiangsu government aimed already in the past at influencing and monitoring – inter alia – the product portfolio, the production capacity build-up as well as the profitability of Jiangsu chemical enterprises.

In a similar vein, the Plan takes stock of the development of chemical industrial park(s) aimed at pulling together the industrial fabric in specific geographical and product areas. The Plan implies that firms outside of the park(s) had to undergo particular difficulties under the previous FYP which translated itself apparently into a direct intervention by the local government. The latter '*has kept promoting specific corrections concerning chemical industry enterprises and has closed down 2 000 chemical industry enterprises, with a relatively small production scale and a relatively high risk as regards safety and environment'*.[1472] One of the claimed reasons for such intervention was that outside of the industrial park '*it is already difficult to maintain the competitive advantages of some products and technologies, [and thus] profitability and market competitiveness shall weaken significantly.'* The Plan puts into question the very existence of enterprises outside of the said park, as a factor threatening the Province's industrial development: *'The question as to whether the development of chemical production enterprises outside industry parks can continue or not, has already become a major uncertainty factor impacting the whole industry's long term stable and sustainable development.'* [1473]

Overall approach

The Plan sets out several general principles to be put into effect by local enterprises, as well as concrete targets regarding the industrial structure of the Province's chemical sector. Regarding the latter, the Jiangsu authorities require relevant parties to:

> *Actively build two petrochemical industry belts: one along the Yangzi River, the other one along the coastal area and grant them a different industry development positioning. Further focus on strengthening the coastal petrochemical industry area, on upgrading the petrochemical industry area along the Yangzi river, on the upstream and downstream integration and concentration of the industry; further focus on development based on industry differentiation, science and coordination between both coastal and Yangzi river areas.* [1474]

Beyond these government instructions on industrial layout development, the authorities require a re-organisation of production processes and capacity:

> *Further develop the adjustment and coordination between quantity increases and the adjustment of existing quantities: ensure the reform of Jiangsu's petrochemical industry development model* [and] *the shift from a development concept based on "quantity increase, capacity expansion" towards a model based on "adjustment of existing quantities, quantity increase, overall quantity*

[1472] Ibid., Section I.2.3.
[1473] Ibid.
[1474] Ibid., Section II.2.1.

> *optimisation"; […] focus on the development of strategic emerging industries, high-end products and cutting-edge technology and the application of new breakthrough technologies; restrict the development of the traditional chemical industry, reduce production overcapacities, eliminate obsolete production capacities, obsolete production equipment and obsolete production techniques.*[1475]

Subsequent sections further detail this insistence on the optimisation and upgrading of existing industrial structures to higher value-added production. In that respect, enterprises are asked to engage faster into new fields of production by '*speeding up R&D and industrialisation of chemical new materials, high-end special chemicals, energy saving and environmental protection technologies as well as other emerging strategic industry technologies*'.[1476] The goal is to force through changes that will bring the Jiangsu chemical companies to international competition standards while building on the current corporate base: '*Adjust existing quantities, raise quantity increases, implement overall quantity optimisation targets: eliminate obsolete production capacities; […]; speed up the establishment of a strong petrochemical province'*.[1477]

To that end, the Plan emphasises the managerial goal of capacity reduction in many low-added value sectors:

> *Set up a mechanism to eliminate obsolete production capacities and adjust existing quantities: as a priority, production overcapacities regarding fertilisers, agro-pharmaceuticals, bi-alkali, basic chemical industry materials, traditional fine chemical products and intermediate products shall be eliminated or reduced. Speed up the development of custom-made chemical products so as to replace obsolete and old products.*[1478]

At the same time it addresses a detailed request to adjust supply/demand patterns in other sectors, with an emphasis on value-added products, thus interfering in the play of market forces:

> *Establish overall quantity optimisation mechanisms based on both the domestic and foreign market demand: focus on meeting both the domestic and international market demand, combine modern general chemical technologies with international chemical advanced technologies, implement an overall quantity optimisation: 1. in accordance with the requirements of the national plan for the petrochemical industry overall arrangement - meet all the needs of the 'Made in China 2025' strategy implementation as well as of the new and emerging industries' development; 2. focus on the development needs of the following four sectors: petrochemical industry, chemical new materials, high-end specialty*

[1475] Ibid., Section II.2.2.
[1476] Ibid., Section II.2.4.
[1477] Ibid., Section III.2.2.
[1478] Ibid.

chemical products, and energy-saving and environmental protection chemical products; 3. rely on the existing industry bases to implement technical innovation resulting in more high-end, more specific, more cluster-organised products and product ranges; […][1479]

Relocation

Geographical management of corporate structures is an important element of industrial policy processes: '*In accordance with the requirements of the key functional areas planning, [Jiangsu shall] define various spatial development areas, formulate tax allocation and staff relocation policies to support enterprises' relocation and winding up of enterprises incurring long-term losses'.*[1480]

Production capacity

In line with the State's interventionist policies, the Plan fixes also particular target levels for the development of production capacity as well as product portfolio and operations structure to be attained by the industry:

- Ensure the full implementation of the Plan as regards adjustment of existing quantities, quantity increase, overall quantity optimisation,
- more than 60% of the traditional chemical industry's existing quantities have to be submitted to the adjustment and optimisation process,
- eliminate obsolete production capacities: reduce obsolete production capacities by more than 10%,
- further optimise production structures: by 2020, the petrochemical industry, the chemical industry's new materials, the high-end special chemicals and the chemical energy saving and environmental protection industry shall account for about 70% of the total operating revenues of the whole industry,
- further optimise and increase quantities.[1481]

Growth targets

Furthermore, the Plan establishes formal growth and income targets for the Jiangsu chemical sector: '*the yearly average growth rate of the Jiangsu chemical industry's business income shall reach about 7.5%, and in 2020 its business income shall be close to RMB 3 trillion*',[1482] as well as specific sub-sectoral market shares and pace of growth related to the industrial parks, which the industry is required to attain by 2020:

The business revenues of the coastal petrochemical industry area shall account for more than 40% of the whole Jiangsu chemical industry,[…], the Jiangsu chemical industry parks (concentration areas) shall be further optimised and shall

[1479] Ibid., Section III.2.2.
[1480] Ibid., Section IV.1.
[1481] Ibid., Section II.3.1.
[1482] Ibid.

start to yield some results: 5 chemical industry parks yielding RMB 100 billion/year of sales revenue shall be built, as well as 20 chemical industry parks of more than RMB 50 billion/year of sales revenue. Chemical industry parks shall account for more than 65% of the whole industry's total business revenue.[1483]

The authorities design in a detailed manner the corporate expansion of the sector and its sub-sectors at various company scales, therefore intervening directing into the supply-generating forces of the market:

At the same time, 8 extra-large-size enterprises (groups) with more than RMB 50 billion business revenue shall be fostered, as well as 20 large-size enterprises with more than RMB 20-50 billion of business revenue, 8 to 10 large-size production and R&D bases in the field of petrochemical industry, chemical new materials, high-end specialty chemicals, and energy saving and environmental protection chemicals shall be built and a number of leading enterprises in sub-sectors shall be created.[1484]

Specific sectors

In another section, the Jiangsu plan encompasses also targets and instructions for distinct groups of products, which are often linked to specific areas of the province. Here are a few examples of the authorities' intent to intervene into the local firms' corporate decisions:

1/ For petrochemicals: *'Achieve diversification of the raw material sources as well as of product series; raise oil resources' efficiency;[…] where the prospects for applications on the domestic and foreign markets are good, consider high-value-added and high-performance materials together with special chemicals as a major target and actively develop the relevant sets of basic chemical materials'.*[1485] The Plan also commands more specifically what steps each region should undertake with respect to the industrial base and its capacity, as well as sources of supply: '*the Nanjing petrochemical base shall ensure the integration and development of refined products, olefins and aromatic hydrocarbons, [and] ensure the high-value development of downstream products'* while the province should also *'promote the construction of the Lianyungang large petrochemical base, and the adjustment and optimisation of Nanjing petrochemical base shall be promoted jointly, scientific planning and coordinated development should be carried out with respect to adjustment, closure, relocation and construction so as to safeguard the stability of supplies of clean oil products and basic raw materials in Jiangsu.'*[1486]

2/ For new chemical materials the Plan aims at supporting the development and industrialisation of high-value added downstream applications such as '*engineering plastics,*

[1483] Ibid., Section II.3.2.
[1484] Ibid.
[1485] Ibid., Section III.1.1.
[1486] Ibid.

high performance fibers, functional membrane materials, fluorine silicon materials, 3D printing materials and other special high-end chemical new materials and their supporting chemicals', while also charging industry with reducing production costs and '*break[ing] the supply bottlenecks as regards upstream key support materials.*'[1487]

3/ For high-end specialty chemicals industry is ordered '*to consider the development and application of advanced integrated smart manufacturing technologies as the guiding line, meet the market's demand for high-performance, functionality, specialisation and customisation'* and especially '*effectively expand the production scale*' of new applications,[1488] which amounts to the authorities ordering supply increases in the market.

4/ Another sub-sector where the authorities go about intervening decisively is agricultural chemicals, including fertilisers and pesticides – a product group which has traditionally featured high production capacity levels. Therefore, the Plan requires enterprises to '*control quantities and scale, reduce the overall number of enterprises, reduce production overcapacities, […] optimise the overall product structure, optimise the specific product structure, [and] optimise resource allocation'*.[1489] In order to manage the existing production capacities built up by numerous companies, the Plan makes further the case for '*rais[ing] the level of industry concentration through mergers and reorganisations, implement[ing] resource-sharing as regards public works and environmental protection facilities, rais[ing] the overall development level of Jiangsu's chemical industry for agricultural use'*.[1490] In the case of fertilisers, in an attempt to rebalance the market, the authorities also order ways to restructure the activity of the sector while trying to ensure at the same time the absorption of existing supply by *'encourag[ing] fertiliser enterprises to implement a combined development model, using the chemical industry's raw materials and special fine chemicals derived from synthetic ammonia, hydrogen, methanol and other resources for which there is a surging market demand'*.[1491]

5/ The Plan also undertakes efforts to regulate the industrial structure of the basic chemicals sector. It sets out as main tasks to: '*optimise the industry's spatial arrangements […] set up scale control mechanisms and production withdrawal mechanisms applicable to the basic chemical raw materials' sectors that have developed production overcapacities and that do not comply with the regional planning*', which amounts to linking the further existence of enterprises to the fulfilment of capacity requirements. Basic chemicals producers are also granted a promise of '*support [for] the establishment of clusters between the basic chemical industry and the downstream industries*'.[1492]

[1487] Ibid., Section III.1.2.
[1488] Ibid., Section III.1.3.
[1489] Ibid., Section III.1.5.
[1490] Ibid.
[1491] Ibid., Section III.1.5.
[1492] Ibid., Section III.1.6.

6/ A similar approach is embraced by the Jiangsu authorities in the area of fine chemicals production, for which the Plan directs relevant parties to '*implement overall control, eliminate obsolete production capacities, consider the market demand, the technological level, the safety and environmental protection as well as the resource usage as the guiding parameters to adjust and optimise the structure of the traditional fine chemical industry'*.[1493] The Plan also orders the geographical optimisation of the sector's structure along the seashore (due to specifically advantageous conditions of the area for the petrochemicals sector) by requiring – in the coastal belt – to '*promote the upgrading of existing traditional fine chemical products* [and, more generally,] *actively undertake domestic and foreign transfers of petrochemical production capacities of an advanced technological level'.*[1494] At the same time, the authorities confirm that the importance of certain other areas should be maintained so as to: '*strengthen the leading role and ripple effect of the related industries on Jiangsu's inland industries'* and they order a complete transformation and upgrading in the value chain of the industry along the Yangtze river:

> *Take the lead as regards the implementation of quantity reduction, elimination, transformation and upgrading of the existing basic chemicals and fine chemicals. In principle, no new petrochemical, basic chemical, agro-pharmaceuticals, fertilisers and traditional fine chemical project shall be built in the area along the Yangzi. It is necessary to take advantage of existing industry bases, to focus on further developing high-end special chemicals, chemical new materials and composite materials having a high technological content, [and] a high added value […].*[1495]

Geographical distribution

The Plan establishes detailed goals with regard to the geographic distribution of the chemical sector in Jiangsu province. For example, in case of the Xuwei New District it sets out to: '*strongly promote the construction of the infrastructures for the petrochemical industry base around the port; actively develop the preliminary works for large-sized integrated refinery projects; complete the public infrastructure and other engineering and construction works for a crude oil terminal, storage area and industry park*', as well as '*orderly complete a number of deep processing projects with methanol and aromatics purchased in foreign markets as raw material, and explore extensions and improvements of the industry chain.*'[1496] In Nanjing city the manufacturers are to '*scientifically plan the production development on the basis of the elimination of obsolete and low-efficient production capacities, and speed up the transfer of some production capacities towards the Nanjing Chemical Industry Park or towards the coastal area*'. Specifically, the Nanjing Chemical Industrial Park is '*to speed up the implementation of industry optimisation and upgrading, the transfer or close down of some*

[1493] Ibid., Section III.1.7.
[1494] Ibid., Section III.2.1.
[1495] Ibid.
[1496] Ibid., Section III.2.1.

rough intermediate or downstream deep processing units, so as to make room for the development of advanced manufacturing and R&D bases for high-end products such as high-end specialty chemical products, [and] chemical new materials, […]'.[1497]

The intervention into the industrial structure is very precisely planned and defined in terms of geographical production specialisation:

> *The Nanjing area shall focus on the development of the petrochemical industry, chemical industry's new materials, high-end special chemical products, bio-energy chemical industry;*
> *The Suzhou area shall focus on the development of synthetic materials derived from olefins, chemical new materials, high-end special and custom-made chemical products;*
> *The Wuxi area shall focus on the development of special functional materials, high-end special chemical products, environmental protection and energy saving chemical products;*
> *The Changzhou area shall focus on the development of synthetic materials derived from olefins, high-end special chemical products;*
> *The Zhenjiang area shall focus on the development of C1 series chemicals and their derivatives, as well as functional chemical new materials;*
> *The Taizhou area shall focus on the development of chemical new materials, high-end specialty chemical products, special basic chemical industry materials;*
> *The Yangzhou area shall focus on the development of bio-based chemical products, environmental protection and energy-saving chemical products;*
> *The Nantong area shall focus on the development of chemical new materials, high-end specialty chemical products, basic materials and products for modern agro-pharmaceuticals.*[1498]

Support

In its last part, the Plan enumerates the instruments of support that the State will use to implement the provisions above:

> *In accordance with the development principles of 'Adjust existing quantities, raise quantity increases, implement overall quantity optimisation':*
> - *set development guidelines and targets as regards the sector's adjustment, upgrading and optimisation,*
> - *grant support through specific funding support, taxation, direct funding and other financial tools;*
> - *increase the support granted to new emerging industries' innovation and business creation investments;*

[1497] Ibid.
[1498] Ibid., Section III.2.3.

- *guide private capital investments towards chemical strategic emerging industries and enterprises in the early/intermediate phase of innovation;*
- *set up 'fault-tolerant' mechanisms,*
- *increase the financial support and assistance to the development of new and emerging industries.*[1499]

These key instruments are backed by other measures, such as by the management of import and export tariffs: *'Set up incentive mechanisms for imports and exports of chemical new high-technologies and products'*, '*eliminate export duties on fertilisers and other products, as well as import duties on natural rubber and other products; increase the export tax refund rate for agro-pharmaceuticals preparations, tires, dyes, synthetic rubber and other products*'. This policy is complemented by export support instruments: '*use tax incentives, specific supports and other methods so as to encourage exports of chemical high-technology.*'[1500] The Plan even provides for the use of trade remedy rules: *'set up and improve systems to ensure the industry's security, reasonably use trade remedy rules to preserve the industry's security.'*[1501]

International activity

One more element of the Chinese State's toolbox is the implementation of a 'reaching out' strategy aiming at expanding economic and investment activity abroad to secure the Plan's goals, by '*actively participat[ing] in the integration and exploitation of world chemical industry resources, focus[ing] on the 'Belt and Road' area and on other developing countries, guid[ing] some production capacities to proceed to relocation in an orderly manner'* and '*attract and gather international advanced production factors*'.[1502] The authorities make it actually clear in the Plan that they will intervene and support such corporate activity abroad by '*support[ing] eligible enterprises to access resource or raw material exporting areas, consumption market countries or areas so as to proceed to investments and build factories, or to mergers and acquisitions, [and] support[ing] enterprises to set up overseas R&D platforms through acquisitions or cooperation, or other means*'.[1503]

16.3.4.2. 13TH FYP FOR THE DEVELOPMENT OF THE PETROCHEMICAL INDUSTRY IN THE HEBEI PROVINCE

Another example of a sectoral provincial plan implementing the provisions of overarching central level plans is the 13th Petrochemical Industry Plan for Hebei Province. Similarly to the

[1499] Ibid., Section IV.2.
[1500] Ibid., Section IV.4.
[1501] Ibid.
[1502] Ibid., Section II.2.5.
[1503] Ibid., Section IV.4.

Jiangsu chemical plan, the Hebei plan sets quantitative development targets,[1504] as well as structural development patterns for specific industries together with capacity control.[1505] It also establishes a number of state support measures to fulfil these goals.[1506] A more detailed description of the Plan can be found in Section 4.2.10.

16.4. POLICY INSTRUMENTS

The plans and guidelines described above provide for a broad array of interventions including production targets, relocation of industries, development of certain industry segments, various forms of support measures, etc. (see also Sections 4.2.8 and 4.2.9). Many of these interventions are very specific and targeted. The following sections highlight certain support measures, which form part of the government's toolbox without being exhaustive.

[1504] '*By 2020, across the whole province, the added value of petrochemical industries above a certain size shall reach RMB 220 billion and an average yearly growth of approximately 9.8%. The crude oil overall processing capacity shall exceed 50 million tonnes'; 'Make sure that the petrochemical industry located in the coastal areas raises its share of the added value generated in the whole province from 38.3% in 2015 to over 45%. The industry enterprises above a certain size and located in parks or bases shall account for more than 70% of the added value generated in the whole province.'*

[1505] *'[…] Foster the setting up of an integrated industry base for aromatic hydrocarbons, ethylene glycol and polyester, strive to reach, by 2020, a yearly production of more than 30 million tonnes of refined oil, and 3 million tonnes of PX; set up complete production equipment of products for which there is an urgent market demand, i.e.: polymer materials, organic chemical raw materials, and high-end fine chemical products, speed up the development of products for which there is high degree of import-dependence such as ethylene glycol, styrene, acrylonitrile, etc.'; 'Strictly control coke production capacities'; 'Speed up the development of coal - ethylene glycol, gradually develop coal (methanol) - olefins, raise the production capacity for non-petroleum-based olefins, build coal-to-aromatic hydrocarbon facilities in appropriate locations of coastal areas, raise the industry concentration level and scaling up, […]'; 'In accordance with the national industry policy and in accordance with the requirements of Hebei's list of industry restrictions and eliminations: strictly implement the sector entry conditions, control any new production capacity project regarding coke, caustic alkali, sodium carbonate, sulphuric acid, calcium carbide pvc, methanol, dyes etc.'; 'Strongly develop biotechnological products such as bio-pharmaceuticals, bio-agro-pharmaceuticals, bio-fertilisers, plant growth regulators, fully degradable films to be used in the agricultural sector, non-grain ethanol, bio-diesel, polymer bio-materials, new types of enzymes, bio-packing materials; strive to make sure that the product refining rate exceeds 60% by 2020'; 'Strongly develop fine chemical industry and chemical industry new materials, speed up the development of specific intermediate products and additives used for agro-pharmaceuticals, pharmaceuticals, paints, dyes, etc.; Develop: functional products and materials for the electronics sector, structural materials for the equipment manufacturing sector, specific products and materials for the textile sector, intermediate products and additives for the pharmaceutical sector, engineering plastic materials for the high-speed railways sector, high-performance fibers for the aeronautics and aerospace sector, membrane materials for the new energy sector, etc.'*

[1506] *'Implement specific tax preferential policies to support industry upgrading at national level, actively seek support from all types of national specific funds, fully absorb state-owned capital and private capital, […], encourage banks and financial institutions located in the province to adjust credit structure as regards the focus given to support amount, maturity, interest rates, etc. […], set up a credit risk compensation mechanism for manufacturing technology innovation and smart manufacturing enterprises.'*

16.4.1. GOVERNMENT-BACKED INVESTMENT FUNDS

All the key documents described above provide that financial policy will be mobilised to support the chemical industry. Beyond the provision of traditional financial support measures, China's central and local governments have established a large number of well-capitalised investment funds to support China's priority sectors. Since the 13th FYP and the Made in China 2025 blueprint, the government is gradually moving away from traditional financial support to new vehicles, such as investment funds. In some cases the funds focus on specific industries and in others more broadly on industrial upgrading.[1507] The creation of well-equipped funds, aimed at channelling public money to priority industrial sectors, increased considerably in 2015 and continued in 2016. Examples of general funds that were established in 2016 include the National New Venture Capital Fund for Emerging Industries, which Vice Chairman Lin Nianxiu of the NDRC stated would receive a capital injection of EUR 5.5 billion.[1508]

Similarly, the National Advanced Manufacturing Industry Investment Fund was set up in June 2016 and controls EUR 2.7 billion for investments in all industries covered by Made in China 2025, which includes the chemical industry.[1509] Approved by the State Council and led by numerous government bodies, the Advanced Manufacturing Industry Investment Fund was jointly established by the State Development Investment Corporation and ICBC Credit Suisse, and includes contributions from the central government.[1510]

In November 2016, MIIT and the CDB, demonstrating the level of coordination related to these funds between different sections of the government, signed a strategic cooperation agreement for jointly implementing initiatives related to Made in China 2025. It was stated that MIIT will provide the guidance policies while the CDB will provide EUR 41 billion of financing support for significant projects and programmes during the 13th FYP period.[1511]

[1507] Zhang, S. and Glenn, E. (2017). *China urges government-backed investment funds to join debt-for-equity scheme*. Reuters, 1 August 2017. http://www.reuters.com/article/china-economy-debt-idUSL4N1KN27U (accessed on 9 August 2017).
[1508] Ifeng Finance. (2016). *National Entrepreneurial Guidance Fund Starts Functioning*. Finance.ifeng.com, 26 August 2016, http://finance.ifeng.com/a/20160826/14813829_0.shtml (accessed on 9 August 2017).
[1509] Ifeng Finance. (2016). *China Sets Up Advanced Manufacturing Industry Investment Fund*. Finance.ifeng.com, 15 July 2016. http://finance.ifeng.com/a/20160715/14601620_0.shtml (accessed on 9 August 2017).
[1510] Dai, Z. (2016). *China Has Established an Investment Fund for Advanced Manufacturing*, MOF website, 15 July 2016. http://www.gov.cn/xinwen/2016-07/15/content_5091658.htm (accessed on 14 December 2017)
[1511] Sina Finance (sourced in Financial Times). (2016). *China Development Bank Will Provide No Less Than 300 Billion RMB Financing Support for China Manufacturing 2025 during the Period of 13th Five-year Plan.* 11 November 2016, http://finance.sina.com.cn/roll/2016-11-11/doc-ifxxsmif2726858.shtml (accessed on 9 August 2017).

16.4.2. GOVERNMENT-DRIVEN OVERSEAS ACQUISITIONS

Over the course of 2015 and 2016, a notable number of outbound investments into chemical firms in Europe and elsewhere have either been successfully completed or attempted. Significantly, many of these investments have been in areas where European business is unable to make equivalent investments in China and have enabled Chinese firms to access technology, brands and management expertise that they would not otherwise have been able to acquire.

Between 2007 and 2010, there were ten Chinese outbound M&A agreements in the EU chemical sector, with a combined value of around USD 211 million. Over the period 2011 to 2016, there were eight Chinese acquisitions of EU chemical companies worth USD 2 billion.[1512] A clear acceleration of Chinese outbound investments in Europe (and elsewhere) is noticeable in the last few years. This trend culminated (to date) in 2016, when Government-owned ChemChina acquired Swiss company Syngenta for USD 43 billion.

Most of these overseas acquisitions have the direct backing of the State (see Section 16.3). Through that state-supported process, Chinese SOEs gain market share, build additional capacities, capital assets and gain access to inputs (see box for details). This has a potential impact on their market position and increased activity in China itself, and influences the cost-pricing patterns of SOEs. Consequently, it has the potential to distort the free play of market forces.

Chinese Mergers and Acquisitions activity[1513]

Strategic acquisitions of western chemical assets by Chinese SOEs started earlier in the 2000s. In 2005, Chinese SOE CNOOC stopped short of a USD 18.5 billion takeover of Unocal in the United States after it spurred wide controversies, while in 2010, similarly, SOE Sinochem gave up on its bid for US PotashCorp. However, in December 2012, the acquisition of Canadian Nexen by CNOOC for USD 15.1 billion was duly cleared and carried forward, even if not without wide political debate.[1514]

The Chinese government has been also promoting the acquisition of natural resources fields around the globe, especially in North America and Africa. In the former case Chinese companies targeted stakes in energy companies, as in July 2012, when certain operations in the North Sea of the Canadian oil company Talisman Energy were acquired by a Sinopec Group subsidiary for USD 1.5 billion.[1515] The Chinese state through its SOEs has also been trying to secure energy supplies such as through the purchase by Sinochem of numerous oil

[1512] Source: Rhodium group, http://www.fdimonitor.com (accessed on 16 October 2017).
[1513] Based on KPMG (2013). *China's chemical industry: The emergence of local champions*. https://assets.kpmg.com/content/dam/kpmg/pdf/2013/10/China-Chemical-Industry-201310.pdf
[1514] See Rocha, E. (2013). *CNOOC closes $15.1 billion acquisition of Canada's Nexen*, Reuters. http://www.reuters.com/article/us-nexen-cnooc-idUSBRE91O1A420130225 (accessed on 9 August 2017).
[1515] See StockMarketWire. (2012). *Talisman Energy completes $1.5bn deal with Sinopec.* http://www.stockmarketwire.com/article/4505893/Talisman-Energy-completes-1-point-5bn-deal-with-Sinopec.html (accessed on 9 August 2017).

and gas fields owned by Petrobras in Brazil, as well as transactions in other oilfields in the Americas, the Middle East and Asia.[1516]

China's SEOs continued to be active in the sector of agricultural chemicals and fertilisers, one of China's most important chemical sectors, which however suffers from important overcapacities. In June 2013, BlueChemical, a subsidiary of CNOOC, acquired stakes in Canada's Western Potash Corp.[1517] Before that, in October 2011, the SOE China National Chemical Corp, or ChemChina, acquired a global player in the agricultural-chemicals sector, Israeli company Makhteshim Agan Industries Ltd, for USD 2.4 billion. This allowed ChemChina to gain better access to other key pesticide markets.[1518] The same SOE ChemChina also took over the Italian company Pirelli for EUR 7.1 billion[1519] and the German producer of rubber machinery KraussMaffei Group for EUR 925 million.[1520]

In April 2017, antitrust authorities conditionally approved the acquisition by ChemChina of Swiss company Syngenta AG for EUR 41 billion.[1521] This is China's biggest overseas deal to date. Since that event, there are suggestions that Chinese state-owned Sinochem and ChemChina consider a merger to create the world's biggest chemical company, and that a deal could be announced by the end of 2017.[1522] Sinochem has operations in seeds, fertilisers and agrochemicals, a line of business that would create synergies with Syngenta, while ChemChina focuses on chemicals, oil processing, tyre and rubber products and chemical equipment. A consolidation of Sinochem and ChemChina could be worth ca. USD 120 billion, topping companies like BASF. At the same time, this transaction also raises the question of the extent to which the Chinese government have been involved in ChemChina's decision. Allegations were also made that the merger of the two SOEs is to give ChemChina the financial capacity to manage the takeover of Syngenta, as ChemChina is plagued with major debts.[1523]

16.4.3. FINANCIAL SUPPORT AND FISCAL INCENTIVES

Despite the fact that China has been phasing out a number of financial incentives in certain sectors, such as fertilisers[1524] (removal of VAT tax rebates, of preferential electricity prices

[1516] See Sinochem website. (2013). *Sinochem Acquires Non-operating Stake in Deepwater Oil Field in Brazil from Petrobras.* http://www.sinochem.com/en/s/1569-5518-17964.html (accessed on 9 August 2017).
[1517] See Western Potash Corp. website. (2013). *Western Potash Corp. receives strategic investment from China Bluechemical Ltd. and Guoxin International Investment Corporation Limited*. http://www.westernpotash.com/news/western-potash-corp-receives-strategic-investment-china-bluechemical-ltd-and-guoxin (accessed on 9 August 2017).
[1518] See Reuters. (2011). *ChemChina takes control of Israel's MA Industries*. http://www.reuters.com/article/chemchina-koor-idUSL5E7LH14T20111017 (accessed on 9 August 2017).
[1519] See Reuters. (2015). *ChemChina to buy into Italian tire maker Pirelli in $7.7 billion deal*. http://www.reuters.com/article/us-pirelli-chemchina-idUSKBN0MI0PQ20150323 (accessed on 9 August 2017).
[1520] See Reuters. (2016). *ChemChina-led group buys Germany's KraussMaffei for $1 billion in record deal*. http://www.reuters.com/article/us-china-kraussmaffei-m-a-idUSKCN0UP0YX20160111 (accessed on 9 August 2017).
[1521] See Reuters. (2017). *ChemChina, Syngenta win U.S. antitrust approval for deal*. http://www.reuters.com/article/us-syngenta-ag-m-a-china-natl-chem-idUSKBN1762O7 (accessed on 9 August 2017).
[1522] See Reuters. (2017). *As Syngenta deal closes, ChemChina and Sinochem press $120 billion deal: sources.* http://www.reuters.com/article/us-chemchina-m-a-sinochem-idUSKBN18J1HR (accessed on 9 August 2017).
[1523] See Weinland, D. and Hornby, L. (2017). *ChemChina and Sinochem plan merger*. Financial Times. http://www.ft.com/content/08a29238-2ed2-11e7-9555-23ef563ecf9a (accessed on 24 August 2017)
[1524] For an overview of the phasing out of incentives for fertilisers: see article on the China Petroleum and Chemical Industry Association website: http://www.cpcia.org.cn/news/hyfx/2015-4/146758.shtml, 22 April 2015 (accessed on 9 August 2017).

for SMEs,[1525] and deregulation of the natural gas price for fertiliser production[1526]), chemical companies still enjoy to a great extent financial incentives provided by the Chinese government, such as regulated gas prices,[1527] or production subsidies for shale gas.[1528]

Moreover, besides the tax incentive programmes that China uses to support the implementation of chemical plans (see Section 16.3), a scheme of rebates on the value-added tax (VAT) of up to 17% have been available for exports and imports of certain chemicals, as well as certain raw materials that are imported to manufacture finished goods for re-export.[1529] The Chinese authorities adjust VAT rebate levels to fulfil industrial policy goals.[1530] For example, in November 2016, China reinstated a VAT rebate (after 11 years) to encourage exports of refined oil products in response to an increase of domestic supply during preceding years.[1531] In addition, the local authorities have particular discretion in managing the VAT rebate policy, potentially allowing them to fulfil objectives related to particular local industrial interests.[1532]

16.5. MARKET DISTORTIONS FOUND IN ANTI-DUMPING AND COUNTERVAILING PROCEEDINGS

Concrete market distortions can also be identified in the results of anti-dumping and countervailing proceedings conducted by several jurisdictions in the world in the chemical sector.

In its *Barium Carbonate* investigation, the EU found that two Chinese exporters were fully or predominantly State-owned, and had a board of directors entirely or predominantly consisting

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[1525] NDRC Circular no. 748 of 13/04/2015 www.ndrc.gov.cn/gzdt/201504/t20150417_688506.html. (accessed on 9 August 2017).
[1526] See NDRC Notice of 10 November 2016, http://www.ndrc.gov.cn/gzdt/201611/t20161110_826177.html (accessed on 9 August 2017).
[1527] See Section 10.2.1, and Zhang. D. (2011). *The Future of Natural Gas in China: Effects of Pricing Reform and Climate Policy*. https://globalchange.mit.edu/sites/default/files/DanweiZhang_MS_2016.pdf (accessed on 7 August 2017).
[1528] See MOF's and NEA's policy on subsidies for shale gas production, dated 17 April 2015. http://jjs.mof.gov.cn/zhengwuxinxi/zhengcefagui/201504/t20150427_1223392.html . (accessed on 9 August 2017).
[1529] VAT rebates are typically adjusted by means of ministerial circulars (see for example: the *Circular on Adjusting the Export Rebate Rates for Certain Products.* Cai Shui [2014] no. 150. http://www.mof.gov.cn/zhengwuxinxi/zhengcefabu/201412/t20141231_1175119.htm (accessed on 1 December 2017).
See also: http://szs.mof.gov.cn/zhengwuxinxi/zhengcefabu/201611/t20161104_2451309.html. (accessed on 9 August 2017).
[1530] See Reports by the WTO Secretariat on the Trade Policy Review for China: WT/TPR/S/300 of 27 May 2014 (paragraph 3.102) and WT/TPR/S/342 of 12 October 2016 (paragraphs 3.108-3.110, as well as Chart 3.3).
[1531] Lin J. and Yu Y. (2016). *China restores tax rebate to shore up refined oil exports*. Icis News. 21 November 2016. https://www.icis.com/resources/news/2016/11/21/10055626/china-restores-tax-rebate-to-shore-up-refined-oil-exports/ (accessed on 9 August 2017).
[1532] See account of the State Council executive meeting chaired by Li Keqiang: 李克强主持召开国务院常务会议. 31 December 2017, State Council website. http://www.gov.cn/guowuyuan/2014-12/31/content_2799117.htm (accessed on 13 December 2017).

of State nominated directors, thereby suggesting the existence of significant state interference in their business decisions.[1533]

In its *Citric Acid* investigation, the EU found that the banking system from which the loans were obtained was under substantial State influence. In addition, one company received private loans worth around 20% of its assets. For all of these loans, no repayment terms had been agreed and no accrual or payment of interest took place. In addition, the company could not present contracts for these loans.[1534] In a subsequent case concerning *Citric Acid*, the EU found that a company benefited from a preferential tax rate.[1535]

In the *Melamine* investigation, the EU found that the costs of the major input, natural gas, was set by the government and was considerably lower than the world market price for gas. This low gas price allowed melamine producers to produce it at artificially low costs, taking advantage of the distorted price of natural gas. Natural gas forms a major part of the cost of urea (around 80%) and urea represents between 50% and 60% of the cost of production of melamine. The EU further found three main types of State interference in the urea market. First, the existence of strict import quotas for urea and export taxes of 110% during mid-season and 10% during off-season. Secondly, the Chinese government has exempted the domestic sale of urea from VAT since 1 July 2005. Thirdly, the Chinese government was directly intervening in the market through the State Fertiliser System, operating since 2004, whereby the State purchases urea directly from producers to it keep in a strategic reserve, with the capacity to release quantities of urea in the domestic market. The EU also found that urea producers benefit from preferential electricity rates and preferential railway freight rates.[1536]

Again in the *Melamine* industry, the United States found, in the absence of cooperation, subsidisation on the basis of the following alleged subsidy programmes in China.

- Preferential Lending:
    1. Policy Loans
    2. Preferential Export Financing from the Export-Import Bank of China
    3. Preferential Loans to SOEs

- Income Tax Programmes:
    1. Preferential Income Tax Program for High- or New-Technology Enterprises

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[1533] Commission Regulation (EC) No 145/2005 of 28 January 2005 imposing a provisional anti-dumping duty on imports of barium carbonate originating in the People's Republic of China.
[1534] Commission Regulation (EC) No 488/2008 of 2 June 2008 imposing a provisional anti-dumping duty on imports of citric acid originating in the People's Republic of China.
[1535] Commission Implementing Regulation (EU) 2015/82 of 21 January 2015 imposing a definitive anti-dumping duty on imports of citric acid originating in the People's Republic of China following an expiry review pursuant to Article 11(2) of Council Regulation (EC) No 1225/2009 and of partial interim reviews pursuant to Article 11(3) of Regulation (EC) No 1225/2009.
[1536] Commission Regulation (EU) No 1035/2010 of 15 November 2010 imposing a provisional anti-dumping duty on imports of melamine originating in the People's Republic of China.

2. Preferential Income Tax Program for High- or New-Technology Enterprises in Designated Zones
3. Preferential Income Tax Program Enterprises in Western China

- Other Tax Programmes:
  1. Tariff Exemption for Imported Equipment
  2. VAT Rebates on FIE Purchases of Chinese-made Equipment
  3. Exemptions from Administrative Charges for Companies in Certain Industrial Zones

- Government Provision of Goods and Services for less than adequate remuneration (hereafter 'LTAR'):
  1. Provision of Land Use Rights for LTAR
     i) Provisions of Land for LTAR to Enterprises in Encouraged Industries in Sichuan Province, Henan Province (Zhumadian District), Xinjiang Province (Shaya County), and Chengdu Province (Qingbaijiang District)
     ii) Land to SOEs for LTAR
     iii) Land Program to Enterprises in Industrial Zones: Zhumadian Industrial Cluster Zone, Yiyuan Economic Development Zone, Shaya Circular Economy Industrial Park
  2. Provision of Electricity for LTAR
  3. The Provision of Inputs for LTAR
     i) Natural Gas for LTAR
     ii) Coal for LTAR

- Grants:
  1. State Key Technology Renovation Project Fund
  2. Environmental Protection Special Fund
  3. Grants to Cover Legal Fees in Trade Remedy Cases
  4. Special Fund for Energy Saving Technology Reform
  5. Clean Production Technology Fund
  6. Grants for Listing Shares
  7. Direct Government Grants to Sichuan Golden-Elephant Sincerity Chemical Co., Ltd.
  8. Direct Government Grants to Anhui Jinhe Industrial Co., Ltd.
  9. Direct Government Grants to Sichuan Chemical Co., Ltd.
  10. Direct Government Grants to Shandong Liaherd Chemical Industry Co., Ltd.[1537]

[1537] Melamine from the People's Republic of China, 80 Fed. Reg. 68847, (final affirmative countervailing duty determination) (Department of Commerce, Nov. 6, 2015).

In its *Monosodium glutamate* investigation the EU found that one company's decisions were not made in response to market signals and without significant State interference, notably because the State was over-represented on its Board.[1538]

In its *Oxalic Acid* investigation the EU found significant State financial intervention affecting the company's cost structure in the form of, e.g. tax holidays and interest free loans.[1539]

In its *Peroxodisulphates investigation*, the EU found significant State interference in business decisions. Indeed, for one company, it was established that the majority of the Directors on the Board, including the Chairman, who owns a significant share in the company, remained the same as before privatisation and had been appointed by the State. They were also found to be members of the CCP. Moreover, the company was unable to prove payment for the shares during the privatisation process. In a second company, which was founded as a State owned enterprise and privatised in 2000, the investigation showed that three members of the management staff that were in post prior to the privatisation conducted the privatisation and still had control over the main decision-making bodies of the company. Those three persons were found to be members of the CCP. Furthermore, this company was found to have provided false information with regard to its ownership and to the privatisation process. As to the third company, it was found that the capital used to start the company was obtained from collectively-owned enterprises managed by the current Chairman of the company.[1540]

In the *Trichloroisocyanuric acid* investigation the EU found that the Chinese State held the majority of the Director posts on the Board of Directors of one company, and that no restrictions applied regarding the State-appointed Directors' voting rights on the Board.[1541]

In the investigation concerning *1-Hydroxyethylidene-1, 1-Diphosphonic Acid*, the United States found that Chinese producers enjoyed electricity for LTAR, an income tax reduction for High and New Technology Enterprises, and self-reported grant programs.[1542]

In the *Ammonium Sulfate* investigation, the United States found that Chinese producers enjoyed benefits under many Chinese subsidy schemes, namely:

> Tax Programmes:
>
> Income Tax Benefits for Domestically-Owned Enterprises Engaging in R&D; Income Tax Credits for Domestically-Owned Companies Purchasing Domestically-Produced

[1538] Commission Regulation (EC) No 492/2008 of 3 June 2008 imposing a provisional anti-dumping duty on imports of monosodium glutamate originating in the People's Republic of China.
[1539] Commission Regulation (EU) No 1043/2011 of 19 October 2011 imposing a provisional anti-dumping duty on imports of oxalic acid originating in India and the People's Republic of China.
[1540] Commission Regulation (EC) No 390/2007 of 11 April 2007 imposing a provisional anti-dumping duty on imports of peroxodisulphates (persulphates) originating in the United States of America, the People's Republic of China and Taiwan.
[1541] Commission Regulation (EC) No 538/2005 of 7 April 2005 imposing a provisional anti-dumping duty on imports of trichloroisocyanuric acid originating in the People's Republic of China and the United States of America.
[1542] DOC, ITA, Countervailing Duty Investigation of 1-Hydroxyethylidene-1, 1-Diphosphonic Acid from the People's Republic of China: Decision Memorandum for the Final Affirmative Determination, March 20, 2017.

Equipment; Preferential Deduction of R&D Expenditures for High or New Technology Enterprises; Preferential Income Tax for Comprehensive Utilization of Resources; Preferential Income Tax Program for High or New Technology Enterprises; Preferential Income Tax Program for High or New Technology Enterprises in Designated Zones; Preferential Income Tax Subsidies for FIEs – Export-Oriented FIEs; Preferential Income Tax Rate for FIEs – High or New Technology FIEs; Preferential Income Tax Subsidies for FIEs – 'Productive' FIEs; Reduction in, or Exemption from, the Fixed Assets Investment Orientation Regulatory Tax; Stamp Exemption on Share Transfer under the Non-Tradable Share Reform; VAT and Tariff Exemptions for Imported Equipment; VAT Exemptions for Certain Nitrogen Fertilisers; VAT Rebates Related to the Comprehensive Utilization of Resources and Other Products; and VAT Refunds for FIEs Purchasing Domestically-Produced Equipment;

LTAR:

Provision of Land to Enterprises in Encouraged Industries for LTAR; Provision of Land to Enterprises in Industrial Zones for LTAR; Exemptions from Administrative Charges for Companies in Industrial Zones; and Provision of Land to SOEs for LTAR;

Inputs for LTAR: Provision of Ammonia for LTAR; Provision of Coal for LTAR; Provision of Electricity for LTAR; Provision of Freight for LTAR; and Provision of Natural Gas for LTAR;

Loan Programmes:

Policy Loans to the Ammonium Sulfate Industry; Preferential Loans for State-Owned Enterprises (SOEs); Preferential Export Financing; Preferential Loans for Key Projects and Technologies; and Loans and Interest Forgiveness for SOEs.

Grants and Other Programmes:

Clean Production Technology Fund; Environmental Protection Special Fund; Exemption from Payments to the Railway Construction Fund for Agriculture-Use Fertilisers; Fertiliser Off-Season Commercial Reserve Program; Grants to Cover Legal Fees in Trade Remedy Cases; Grants for Listing Shares; Special Fund for Energy Saving Technology Reform; and State Key Technology Renovation Fund.[1543]

In its *Calcium Hypochlorite* investigation, the United States found that Chinese producers enjoyed benefits under the following schemes:

Preferential Lending for Industrial Readjustments, Preferential Loans Provided by the Export-Import Bank, Export Credits from China's Export-Import Bank, Shareholder Loans (Debt Forgiveness), Discounted Loans for Export-Oriented Enterprises, Loans for SOEs, Corporate Income Tax Law Article 33, Income Tax Credits on Purchases of Domestically Produced Equipment by Domestically Owned Companies, Stamp Tax

[1543] Decision Memorandum for the Preliminary Affirmative Determination in the Countervailing Duty Investigation of Ammonium Sulfate from the People's Republic of China, October 24, 2016.

> Exemption on Share Transfers under Non-Tradable Share Reform, VAT and Tariff Exemptions on Imported Equipment for Favoured Industries, VAT Rebates on Domestically Produced Equipment, Free Allocation of Land, Land Acquisition Through Agreement, Provision of Shipping for LTAR, Provision of Electricity for LTAR, The State Key Technology Renovation Fund, Funds for Clean Production and Water Treatment, Special Fund for Energy Saving Technology Reform, Export Credit Insurance from China Export and Credit Insurance Corporation (Sinosure), Retention of Land Rents, Famous Brands Program, Foreign Trade Development Fund.[1544]

In its *Chlorinated Isocyanurates* investigation, the United States found that Chinese producers enjoyed benefits under the following schemes:

> Grants for export credit insurance, Special funding for energy saving technology, Export seller's and buyer's credits from Export-Import Bank of China, Corporate income tax law article 33 (reduction of taxable income for the revenue derived from the manufacture of products that are in line with state industrial policy and involve synergistic utilization of resources), Grants under the Haixing County science and technology research & development plan project, Special national bond fund for energy conservation and waste recycling projects, VAT tax rebate for comprehensive utilization of resources, Shandong industrial structure adjustment entrusted loan, Enterprise income tax reduction for high and new technology enterprises, Electricity for LTAR.[1545]

In its *1, I, I ,2 Tetrafluoroethane* investigation, the United States found that one Chinese producer was 100% owned by a company, which in turn was 55.86% owned by an SOE supervised by Zhejiang province SASAC. Based on this factor, and other business proprietary information, the United States found that the Chinese state controls the selection of the company's management and thus *de facto* controls the company's decisions. In the same investigation, the United States found that two more companies are under *de facto* government control.[1546]

16.6. CHAPTER SUMMARY

The Chinese chemical sector, the world's biggest, is one of the building blocks of China's industry. Not only does it provide final consumers with products necessary for their daily lives, but it also supplies essential inputs for many other key sectors. Being both at the upstream and downstream ends of value chains, it has always benefited from particular

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[1544] Final Affirmative Determination in the Countervailing Duty Investigation of Calcium Hypochlorite from the People's Republic of China (December 2014) http://enforcement.trade.gov/frn/summary/prc/2014-29368-1.pdf
[1545] DOC, ITA, Countervailing Duty Investigation of Chlorinated Isocyanurates from the People's Republic of China: Issues and Decision Memorandum for the Final Determination, September 8, 2014.
[1546] Preliminary Determination in the Antidumping Duty Investigation of 1, I, I ,2 Tetrafluoroethane from the People's Republic of China, September 29, 2016, http://enforcement.trade.gov/frn/summary/prc/2016-24358-1.pdf (accessed on 16 October 2017).

attention from the Chinese government. State control transpires through numerous planning and regulatory documents issued over the course of decades by legislatures and administrative agencies at all levels of government. This plethora of legislative and administrative acts aims – as in the case of other strategic industrial sectors – at the comprehensive management of the industry's development, often orchestrated in great detail. It is based on a specific vision of a chemical sector serving China's higher economic and ideological goals, and therefore shaped not by the markets but by the State.

As China transforms its economic sectors to become more value-added and quality- rather than quantity-oriented, the State's model and vision for the chemical sector has evolved. The industry is now expected to become self-sufficient in all aspects, including in high-end products, with the purpose to build new value chains, serving Chinese industries and the evolving society of consumers, as well as entering new segments in global markets. However, the Chinese chemical industry has long been developing mainly low-end and high volume chemical production capabilities, which have resulted in vast overcapacities of certain product groups, having also as an effect the dumping of some of these goods in foreign markets. On the other hand, high value-added products such as speciality and fine chemicals are still largely imported into China and therefore do not fulfil the State's goal of self-sufficiency. As in the case of many other sectors, this dichotomy is a major problem for the Chinese government in the implementation of its 'new normal' policies. As in the past, when the State steered industrial processes into massive production of basic chemicals, it now aims at restructuring the chemicals market once again by directly intervening into corporate decision-making and impacting supply and demand, thus distorting the market in various chemical sub-sectors through a plethora of measures.

These interventionist actions are first and foremost visible in the system of state plans directed to various government bodies and enterprises. Through these documents, the State and the CCP – besides giving development directions and guidance – also seek to manage in great detail not only production methods (as to achieve environmental and innovation goals) but most importantly also production capacity (and therefore market supply). At the same time, to this end, Chinese authorities are forcing – through specific demand patterns (which in the case of the chemical sector can be enforced notably by further managing production capacities in downstream sectors), manipulating the industrial fabric's structure and location, and influencing the product portfolio of companies. The execution of these provisions is carried out in a top-down manner through sequences of sectoral chemical plans at the central, provincial, local, even municipal levels across a broad geographical setting, as chemical companies of all sizes are located in virtually the whole country.

The State influence is all the more pronounced as the chemical sector's top players are predominantly SOEs, and even if their overall sectoral share has decreased somewhat in recent years, this still gives authorities direct control over significant parts of the market.

The plans' provisions aiming at managing the industry and the market, take the form of direct requirements or regulations (e.g. relocation requests, production targets or restraints) or the form of specific support instruments, in most cases of a financial, fiscal or cost-reducing

nature, with the aim to push companies into making the required decisions. The latter means encompass notably grants, preferential loans, tax rebates, land-use permits, energy price rebates or special access to inputs. Indeed, in China's state-run economy, the government – as a player of multiple roles controlling factors of production – has the capacity to fully manage these factors in order to achieve its industry policy goals.

All of these planning measures are applied at various administrative levels in a discretionary, controlled and systematic manner – on a massive scale – and are subject to constant review by the authorities. As such, they indirectly or directly affect supply, demand and prices, through limits or incentives to produce certain chemicals or to relocate activity to other sub-markets, through relieving the production costs of certain companies, or through supporting the acquisition of new production capacities abroad. All these measures significantly affect or impede the free functioning of the market as well as company decisions, which are no longer genuinely market-driven.

17. CERAMIC SECTOR

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17.1. PRODUCTS CONCERNED

The ceramic sector generally covers the following products: wall and floor tiles, bricks and roof tiles, refractories, sanitary ware, table and ornamental ware, technical ceramics, abrasives, clay pipes, expanded clay and porcelain enamel.

These products are covered by the following HS codes:

HS 3801 (refractory products);
HS 3816 (refractory products);
HS 6815 (refractory products);

HS 6901 (refractory products);
HS 6902 (refractory products);
HS 6903 (refractory products);
HS 6904 (ceramic bricks);
HS 6905 (roof tiles);
HS 6906 (clay pipes);
HS 6907 (ceramic tiles);
HS 6911 (tableware and kitchenware)

17.2. THE CHINESE (CONSTRUCTION) CERAMIC INDUSTRY

17.2.1. PRODUCTION

China is the world's largest producer of ceramic tiles, being home to more than half of the worldwide ceramic tile production. In 2016, there were 1 777 Chinese ceramics producers (representing an increase of more than 20% compared to 2014).[1547]

Between 1995 and 2014, Chinese ceramic tiles annual production increased by more than six times, amounting to 1.6 billion m^2 in 1995, 8.7 billion in 2011 and 10.2 billion m^2 in 2014, exceeding then 10 times the EU's total ceramic tiles production. In 2016 production reached 11.1 billion m^2/year (representing an additional rise of 8.8% compared to 2014).[1548]

At the same time, the Chinese yearly capacity built-up followed an even steeper upward trend than production itself: with 10.8 billion m^2 of capacity in 2011, 13.9 billion m^2 in 2014 and 17 billion m^2 in 2016.[1549]

The Chinese construction ceramic industry has a low market concentration rate. The top ten manufacturers account for less than 5% of the Chinese total capacity.[1550] Ten ceramic production regions have daily ceramic tiles output of more than 1 million m^2 with a total daily capacity of ca. 25 million m^2, representing 55.6% of the Chinese total capacity.[1551] According to a list of leading Chinese construction ceramics producing regions in 2014, the first ten included: Zhaoqing (largest ceramic tiles producing region with a yearly capacity of 1.22

[1547] Commission Implementing Regulation (EU) No 2017/2179 of 22 November 2017 imposing a definitive anti-dumping duty on imports of ceramic tiles originating in the People's Republic of China following an expiry review pursuant to Article 11(2) of Regulation (EU) 2016/1036 of the European Parliament and of the Council (OJ L 307, 23.11.2017, p. 35).
[1548] Aegis Europe. (2016). *Press release: European manufacturing industries call on G20 leaders to tackle widespread Chinese overproduction and overcapacities.* 2 September 2016. See also data of the China Building Ceramics and Sanitaryware Association, http://www.china-china.cn (accessed on 16 October 2017).
[1549] China Building Ceramics and Sanitaryware Association data, http://www.china-china.cn
[1550] China Market Research Reports, China Ceramic Tile Industry Report, 2015-2018, available at http://www.chinamarketresearchreports.com/115287.html (accessed on 16 October 2017).
[1551] Ceramic Information. (2016). *Construction ceramics in China: a data compilation over 20 years.* 14 January 2016. http://www.taoci-info.com/news/show.php?itemid=6991 (accessed on 18 December 2017).

billion m^2), Foshan (2nd biggest producing region), Qingyuan (769.1 million m^2) and Jiangmen (515.8 million m^2) in Guangdong province. This implies that despite the relocation of ceramics capacity out of Foshan, Guangdong still dominates the sector, with only Fujian province as a close runner-up. [1552]

17.2.2. EXPORTS

On the global export market, total Chinese exports of ceramic tiles more than doubled from 543 million m^2 in 2006 to 1 138 million m^2 in 2015.[1553] In particular, the increase of exports occurred in 2015 in comparison to 2014: in June 2015, 102 million m^2 of ceramic tiles were exported – an increase of 23.86% compared with the same month of 2014, whereas the export volume of Chinese ceramic tiles in the first six months of 2015 amounted to 506 million m^2, growing by 6.02% when compared with the same period of 2014.[1554] The export volume stood at 867 million m^2 for the period between January and October 2016.[1555]

The increase in Chinese exports worldwide results from the imbalance between supply and demand on the Chinese domestic market, leading to the aggravation of the structural overcapacity problem as analysed below.

While this section concerns exports of ceramic construction products, it is also worth adding that Chinese global exports of ceramic sanitaryware increased from 46.09 million of units in 2009 to 79.75 million in 2015. In 2015, the exported volume represented 36.49% of Chinese production.[1556]

17.2.3. OVERCAPACITY OF CHINESE CONSTRUCTION CERAMIC INDUSTRY

As stated above, Chinese statistical sources indicate that the Chinese construction ceramic industry increased its ceramic tiles production capacity by nearly 30% between 2011 and 2014 (from 10.8 billion m^2/year to respectively 13.9 billion m^2/year), and thereafter by 22% between 2014 and 2016 (to 17 billion m^2).[1557]

Unutilised production capacity expanded from 20% in 2011 to 26% in 2014 and to 35% at the end of 2016, reaching almost 6 billion m^2, with a spare capacity increase of 3.8 billion m^2

[1552] Ibid.
[1553] Yin, H. (2016). *Comprehensive description of the development of the construction and sanitary ceramic sector at the national level in 2015.* Ceramic Information. 30 May 2016. http://www.taoci-info.com/news/show.php?itemid=7688 (accessed on 18 December 2017).
[1554] *Ceramic Town Weekly*, Special Edition, no. 19, September 2015.
[1555] Zhang, Y. (2016). *2016 Key data on construction ceramics and related industries*. Ceramic Information. 28 December 2016. http://www.taoci-info.com/news/show.php?itemid=8893 (accessed on 18 December 2017).
[1556] Yin, H. (2016). *Comprehensive description of the development of the construction and sanitary ceramic sector at the national level in 2015.* Ceramic Information. 30 May 2016. http://www.taoci-info.com/news/show.php?itemid=7688 (accessed on 18 December 2017).
[1557] Commission Implementing Regulation (EU) No 2017/2179 of 22 November 2017.

over the said five years. Chinese overcapacity numbers exceeded therefore several times the total European Union annual consumption, which stood at around 0.9 billion m^2 in mid-2016.[1558]

Moreover, in its relevant anti-dumping investigation the European Commission established that in a period between 2013 and mid-2016 *'the capacity utilisation of the verified exporting producers decreased from 74% to 54% and the number of employees went down by 25%. Producers stopped production during two months during the first quarter 2017 […]'*, as well as that *'the Chinese exporting producers have accumulated significant stocks […]. Based on the information from the sampled Chinese exporting producers the stocks may represent up to two third of their ceramic tiles production.'*[1559]

The serious problem of structural overcapacity in China is confirmed in the Guiding Opinions for the 13th Five-year Plan on the Development of Construction Ceramics and Sanitary Wares ('Industry guiding opinions') issued by China's ceramic sectoral association. Section II.1 of the document stipulates:

> *During the 12th FYP periods, the productivity and output of the main products of construction ceramics and sanitary wares have been excessively increased. The national production capacity of construction ceramics in 2015 has exceeded 13 billion square meters, while a quarter of national production capacity was not utilized. With China's macro economy entering into a new normal state and the growth speed of real property slowing down, the growth of market demand for construction ceramics and sanitary wares also slowed down, which will intensify the imbalance between market demand and excessive production capacity during the 13th FYP period.*

Massive unutilised capacity is affecting the ceramic sector, as well as a number of energy-intensive Chinese industries (see also Sections 14.4 and 15.5).[1560] The fact that in China market share is often seen as more important than profitability – and overcapacity is viewed as an opportunity to gain market share – results in the problem of structural long-term overcapacity. According to statistics, China's ceramic tile industry recorded an output increase of 11% and a sales increase of 6% in the first half of 2015, revealing imbalances between supply and demand. As a result, many ceramic tile companies cut down products prices leading to price wars where products are sold nearly without any profit.[1561]

[1558] Ibid.
[1559] Ibid.
[1560] The EUCCC identified several reasons for this structural overcapacity problem in China in: EUCCC. (2016). *Overcapacity in China, An Impediment to the Party's Reform Agenda*, p 7-15.
[1561] *Ceramic Town Weekly*, Special Edition, no. 19, September 2015.

17.3. REGULATORY FRAMEWORK

The scrutiny of the legal framework regulating the ceramic sector in China is a paramount element in the identification of State interference leading to significant market distortions. At the same time, ceramic products have various consumer and industrial uses, and therefore the sector is managed by different state policy instruments. An important part of ceramic goods, in particular ceramic tiles and pipes, are considered as construction materials and therefore are covered by the rules pertaining to that sector. Another group of ceramic products – namely tableware - falls under the category of light industries. The relevant measures pertaining to these sectors are described below. It can be safely assumed that the general provisions which apply to the construction sector or the light industries sector cover also *per se* the ceramic sector.

17.3.1. THE 13TH FYP FOR THE CONSTRUCTION MATERIALS INDUSTRY

On 11 October 2016, MIIT issued the Construction Materials Industry Development Plan 2016-2020 ('the Plan'). It was drawn up on the basis of the national 13th FYP and the Made in China 2025 strategy, as well as on the basis of the relevant State Council's Guiding Opinions (see Section 17.3.2) as the policy document for the years 2016-2020 shaping the construction materials industry's development and structure, and the supply-demand patterns of the market.

While the current Plan confirms the continuous expansion of the construction materials sector beyond the 12th FYP period, including for the ceramic sector,[1562] it also acknowledges that the current condition of the sector is not in line with the State's vision as '*changes in the demand structure and shortages of efficient supplies require the construction material industry to optimise and adjust its structure,*[…] *to foster supply-side structural reforms, to resolve overcapacities, to increase efficient supplies*', together with a goal to '*conquer new territories for its development*'.[1563]

The objective to manage the restructuring of production capacities and supply is subsequently put in the limelight: '*Raising the overall basic capacities requires the construction material industry to strengthen as soon as possible the security of supply of advanced non-organic, non-metal materials and composite materials*'.[1564]

The Plan clarifies further that this should translate into a requirement to, among others, '*consider supply-side structural reforms as the guiding thread*'; '*focus on reducing*

[1562] Construction Materials Industry Development Plan 2016-2020, Section I.1: '*In 2015 the construction ceramic production volume reached 10.18 billion m^2, up 30.5% compared to 2010'.*
[1563] Ibid., Section II.1.
[1564] Ibid.

overcapacities'; '*transform and improve the traditional sector*'; '*optimize the allocation of the main factors*' and '*establish new sectoral systems'*.[1565]

State intervention goes as far as establishing specific quantitative targets for business profitability stating that the '*average effective business income per enterprise exceeding a certain size'* should be 1.3 million RMB in 2020, as opposed to 1.1 million RMB in 2015.[1566]

The State mandates various tasks to achieve these goals. One of the main aims is to further modify the production patterns of companies: '*the replacement of traditional construction materials shall be speeded up*'; '*production overcapacities and mismatches shall be basically resolved*' and '*the level of concentration of the industry shall increase*'.[1567]

The Plan goes into great detail in steering the process, enumerating '*specific actions to reduce production capacities*': not only does it '*impose withdrawals of production capacities lacking competitiveness*' and requires relevant parties to '*adequately restrict production*' but it also implies that enterprises should be assisted to collude in order to reach specific supply patterns: '*Support competitive enterprises to set up production capacity integration platforms'*.[1568] Specifically, the Plan directs the State administration to '*implement policies such as differentiated prices, or differentiated price categories for electric power in highly energy consuming sectors*',[1569] giving a clear consent for State-controlled differentiation of pricing of inputs, imposed to reach the policy goal of managing production capacity. Such process has the capacity to distort market supply, through an additional distortion in the energy market.

In other sections, the Plan imposes industry restructuring processes, including across the value chain, calling for '*speed[ing] up the replacement and upgrade of the traditional construction materials*' and '*expand[ing] the industry chain*'.[1570] Among others, the Plan stipulates that in such processes the State '*guide[s] and support[s] construction materials enterprises in the field of construction and sanitary ceramics*'.[1571]

The process of managing the construction materials industry contains also a geographical dimension, as the Plan directs not only in a general manner to '*ensure the overall planning of resources, environmental capacities, transport logistics, market demand and other factors'* but also calls for establishing specific industrial activities in particular locations, including through the concentration of production capacities: '*in the periphery of areas having a resource comparative advantage or in areas planned to be set up, support the development of specific non-metal mineral mining dressing and deep processing*' and '*ensure the emergence of a number of production bases with distinctive characteristics and industrial*

[1565] Ibid., Section III.1.
[1566] Ibid., Table 2.
[1567] Ibid., Section III.3.
[1568] Ibid., Table 3.
[1569] Ibid.
[1570] Ibid., Section IV.1.1.
[1571] Ibid., Section IV.2.3.

concentration'.[1572] Specifically in the case of the ceramic sector, the Plan further envisages a transfer of the construction and sanitary ceramic industry from the Eastern regions to Guangxi – and the strengthening and upgrading of the ceramic industry in the North-Eastern region in Liaoning and in the Central and Southern regions in Guangdong and Sichuan.[1573]

Despite containing provisions on capacity reductions, the Plan also mandates an '*increase [of] the capacity to ensure supply security for key basic materials*'.[1574]

The Plan also requires the State organs and industry to steer the interactions between demand and supply for specific product groups with recommendations such as: '*Better meet the market demand*;' '*Increase the number of marketable products*'; '*better meet the differentiated consumption demands*' or '*encourage backbone enterprises in the kitchen, sanitary, ornamental material sectors to take care of the market hotspots and consumption preferences, to foster customisation and flexible production, so as to meet the differentiated needs of consumers*'.[1575] In a concrete proposal, it puts forward the idea of a project to develop mineral functional materials in which market players and the State are to explicitly '*consider the demands of […] high-end equipment and other sectors as the guiding factor*'.[1576] In the case of ceramics, the Plan suggests to influence demand for certain products by calling to '*promote the use of thin and functional ceramic tiles*'.[1577]

As in the case of other sectors, the State endeavours to set up or expand industrial parks, which would concentrate a region's industrial base. The Plan makes no exception to this practice, requiring such parks to be established for mineral functional materials, together with specific production capacity targets: '*In 2020, the output of such specific parks shall reach RMB 10 billion'*. Besides that, the Plan requires that the development of mineral functional materials shall be driven by large enterprises.[1578]

Similarly again to other sectoral plans, the ceramic sector is also subject to planning provisions going beyond the Chinese domestic markets. Leading enterprises are to engage in foreign operations and acquisitions '*in accordance with the win-win principle […] to combine their advantages by using their capital and participate in international market investments and business via mergers, restructurings, equity investments etc.*' The Plan warrants that the State '*support[s] eligible construction material enterprises to actively participate in the international division of labour and cooperation through the use of world resources, the*

[1572] Ibid., Section IV.1.2.
[1573] Ibid., Table 5.
[1574] Ibid., Section IV.1.3.
[1575] Ibid., Section V.5.
[1576] Ibid., Section V.3.
[1577] Ibid., Table 4.
[1578] Ibid., Section V.3.

reengineering of the business processes, the integration of the industry supply chain, the use of capital markets and other means'.[1579]

In a last part, the Plan sets out provisions regarding its implementation, which '*shall be ensured by the administration in charge of industry together with the relevant administrations'*. It underlines that '*it is necessary to focus on the Plan's objectives and tasks*', making it clear that this means '*organis[ing] the relevant projects in accordance with the Plan and the industry policy*'. The implementation process is to be driven top-down, through the various governmental levels as '*all regional administrations in charge of industry shall take into account the reality of the relevant region as well as the development and structural adjustment of the region's construction material industry, […] so as to duly implement the present Plan's development objectives, main tasks and major projects'. Enterprises are to be 'fully involve[d] […] as pillars in the implementation process*'.[1580]

The Plan announces that its due execution will be scrutinized: '*it is necessary to set up dynamic evaluation mechanisms to assess the present Plan's implementation*'.[1581]

In that respect, the Plan requires also that '*operational supervision on the sector [be] strengthen[ed]*'.[1582]

Finally, the Plan lays out a multi-faceted array of instruments the State should employ to implement the above provisions. Above all, it states that '*support policies should be improved*'. This should translate into a broad policy of *'strengthening the connexions between the industry policy and the fiscal and tax policy, financial policy, energy policy, environmental policy and other relevant policies,'* including also *'a price policy'*. It is not specified further what is meant by the latter term, but this would point to a direct State intention to intervene in the free market play of price-shaping forces.

The Plan stipulates broadly that the State is to '*support enterprises to proceed to a technological transformation*'. To that end, authorities are advised to '*examine how to put forward a list of technologies, products and projects supported in priority*'. The Plan also requires authorities to '*implement differentiated support policy based on protection and control.*'[1583]

With regard to its provisions on the boosting of foreign acquisitions, the Plan also delivers for national players the promise to 's*upport all types of construction material enterprises' mergers and restructuring by providing merger/acquisition loans, merger/acquisition*

[1579] Ibid., Section IV.5.2.
[1580] Ibid., Section VI.6.
[1581] Ibid., Section VI.1.
[1582] Ibid., Section VI.3.
[1583] Ibid., Section VI.2.

securities, direct funding and other forms of participation.'[1584] Such support demonstrates the high degree of state intervention into corporate decisions in the M&A field.

17.3.2. STATE COUNCIL GUIDING OPINIONS ON THE CONSTRUCTION MATERIALS INDUSTRY

In May 2016, not long before the adoption of the 13th FYP for the Construction Materials Industry, the State Council issued the Guiding Opinions on Promoting Steady Growth, Structural Adjustments and Efficiency Gains in the Construction Materials Industry ('the Opinions')[1585]. MIIT authorities provided further interpretation to this document.[1586] The latter acknowledged that the Opinions '*fully embody the Central Committee's and the State Council's concerns and support as to the construction material industry*'.[1587]

The Opinions – quite naturally – largely coincide with the overarching document that followed them. The guiding principles contained therein aim at managing excess capacity and industry structural patterns towards upgraded value-added production processes. That is to be accompanied by a concentration of production, modified supply structures, and utilisation of resources. In particular, the Opinions impose a prohibition on new increases of production capacity for certain products,[1588] which largely amounts to State regulation of market supply.

As confirmed by MIIT, the goal of the Opinions is to achieve SSSR in the construction material sector, 'o*ptimize production structures*', '*speed up the change in business model'* and formally *'regulate the market order*'.[1589]

The Opinions go quite in detail in terms of industrial guidance, including for ceramic products: '*strongly develop specific equipment for the production and testing of […] fine ceramic precursors and ceramic powder*.'[1590]

As confirmed later by the 13th FYP, the State Council also charges subordinated levels of administration to '*support enterprises to gather in special parks*'.[1591]

[1584] Ibid.
[1585] State Council Guiding Opinions on Promoting Steady Growth, Structural Adjustments and Efficiency Gains in the Construction Materials Industry, Guo Ban Fa [2016]. no. 34. http://www.gov.cn/zhengce/content/2016-05/18/content_5074416.htm (accessed on 16 October 2017).
[1586] MIIT. (2016). Interpretation of the State Council Guiding Opinions on Promoting Steady Growth, Structural Adjustments and Efficiency Gains in the Construction Materials Industry. 24 May, 2016. http://www.miit.gov.cn/n1146295/n1652858/n1653018/c4807465/content.html (accessed on 16 October 2017).
[1587] Ibid.
[1588] State Council Guiding Opinions on Promoting Steady Growth, Structural Adjustments and Efficiency Gains in the Construction Materials Industry. Section II.4.
[1589] MIIT. (2016). Interpretation of the State Council Guiding Opinions on Promoting Steady Growth, Structural Adjustments and Efficiency Gains in the Construction Materials Industry. 24 May, 2016.
[1590] State Council. Guiding Opinions on Promoting Steady Growth, Structural Adjustments and Efficiency Gains in the Construction Materials Industry. Section III.13.
[1591] Ibid., Section IV.14.

The Opinions confirm that a toolbox of financial support measures, as seen in other sectoral plans and documents, will be applied and even expanded in order to achieve policy goals.[1592]

Such support is managed according to specific needs as the Opinions require the relevant parties to '*implement the financial policy guaranteeing financial support in some sectors while limiting it elsewhere*'. Changes in production capacity should be achieved by means of financial support: '*as regards construction material enterprises resolving production overcapacities, implementing mergers and restructuring*.'[1593]

The State Council also proposes, as in the case of other sectors, to intervene in supporting investment in mergers and acquisitions of construction material enterprises by '*expanding financing channels through offering merger loans or merger securities.*'[1594]

The MIIT reiterates that support measures, as put forward by the Opinions, would consist of financial '*guarantees and controls*, *broaden[ed] financial channels thanks to loans, securities'* and '*support* [to] *all types of private capital to participate in mergers and acquisitions of construction material enterprises.*'[1595]

The Opinions also develop an additional provision regarding State support: they set up '*the creation of a catalogue of technologies and products which the construction industry is encouraged to use*' on the basis of which the authorities would '*implement a differentiated credit policy for the construction industry's projects related to […], product upgrade and substitution, […]'*.[1596]

17.3.3. INDUSTRY GUIDING OPINIONS FOR THE 13TH FYP ON THE DEVELOPMENT OF CONSTRUCTION CERAMICS AND SANITARYWARE

China's ceramic sectoral association (China Building Ceramics & Sanitaryware Association) issued in 2016 its own *Guiding Opinions for the 13th Five-year Plan on the Development of Construction Ceramics and Sanitaryware* ('Industry guiding opinions').

The document further identifies the main problems of China's construction ceramics and sanitaryware industry (see Sections 17.3.1 and 17.3.2 above): excessive production capacity, weak innovation capacity, low end value chain of most parts of the industry and export of low-priced products.[1597]

[1592] Ibid., Section V.19.
[1593] Ibid.
[1594] Ibid.
[1595] MIIT. (2016). Interpretation of the State Council Guiding Opinions on Promoting Steady Growth, Structural Adjustments and Efficiency Gains in the Construction Materials Industry. 24 May, 2016.
[1596] State Council Guiding Opinions on Promoting Steady Growth, Structural Adjustments and Efficiency Gains in the Construction Materials Industry. Section IV.15.
[1597] See China Building Ceramics & Sanitaryware Association. (2016). *Guiding Opinions for the 13th Five-year Plan on the Development of Building Ceramics and Sanitaryware.* Section II.1.

The industry document picks up on the relevant State document provisions described above by acknowledging the need to '*Vigorously promote the optimization of enterprise organization structure*,[…] *encourage large scale enterprises with strong innovative ability and high management skill to take advantage of the comparative advantage such as technology, management, brand or capital,* […] *revive the remaining enterprises, carry out merger and reorganization,* […] *vigorously promote the transformation of industrial structure, accelerate the pace of merger and reorganization, and support strong and excellent enterprises.*'[1598]

There is also a specific mention on how the industry sees the management of the sector – by supporting, transforming or eventually scrapping entire companies – something presented as the strategy of '*support one batch, transform one batch and eliminate one batch'*.[1599]

Most importantly, however, the association recognises its support for the State's intervention in the industry's activity and decision-making: '*We shall give full play to the government's macroeconomic regulation and control, guidance from industrial policy, and the function of coordination and bridge link of the industry Association*.'[1600]

17.3.4. 13TH FYP FOR THE LIGHT INDUSTRY

An important segment of the ceramic goods industry – table- and sanitaryware – is covered by the Chinese rulebook governing light industries, with the main measure being the 13th Light Industry Development Plan for the years 2016-2020 (hereafter 'the Plan'). Like other similar documents, the Plan explicitly acknowledges that its content is based on CCP decision-making and ideology: '*implement the spirit of the 18th National Congress of the CPC and the Third, Fourth and the Fifth Plenary Session of the 18th Party Congress, comprehensively implement the "Made in China 2025*"'.[1601]

The Plan directs the relevant parties '*to improve the supply structure*' confirming the authorities' intent to steer the light industry markets.

According to the Plan, light industries fared well during the past few years: in 2015 exports of light industrial products were worth 592.84 billion USD – an increase of 71.6% compared to 2010. Also, during that period, '*the average annual growth rate of light industry's industrial added value, business income, total profit and export volume reached 10.1%, 14.0%, 15.4% and 11% respectively*'. The Plan hails the prevailing role of the Chinese light industrial sector:

[1598] Ibid., Section V.1.
[1599] Ibid.
[1600] Ibid., Section VI.4.
[1601] 13th Light Industry Development Plan (2016-2020), Section II.1

'*the overall competitiveness was further enhanced and China's status as a world's large producing, consuming and exporting country of light industry products was consolidated*.'[1602]

It also praises the positive outcome of past structural adjustments: '*industry clusters have boomed*' and '*the level of industry concentration significantly went up, the top 100 enterprises accounted for 10.6% of the business income and 13.1% of the profit of the light industry as a whole*.'[1603]

However the authorities also pinpoint some of the issues that do not fit the State's vision of the sector: among others '*in some traditional industries […] the new competitive advantage has not materialised yet*' and '*over the 13th FYP period of time, the task will be difficult and complicated for light industry to maintain steady growth, improve supply structures, break development bottlenecks and implement transformation and upgrading*',[1604] therefore as one of its guiding ideologies, the Plan undertakes to '*promote the structural reform of the supply side*', and '*optimize industry structures*',[1605] together with the need to *'strengthen market surveillance, [and] improve the relevant systems, […].* '[1606]

Besides its provisions on supply management, the Plan also puts forward general ideas aiming at steering demand for light industry products, which very often consist of daily consumer goods, as in the case of ceramic tableware and sanitaryware. The State intends to use its entire toolbox to stimulate consumption of light industry goods – including through childbirth policies:

> *Consumption upgrading provides the industry with huge development opportunities. China has the world's largest consumption market; the current urban and rural consumption structures are shifting from a subsistence-based consumption towards a development-based consumption, from a goods-based consumption towards a service-based consumption, from a traditional consumption towards new types of upgrading consumption. The rigid demand of various groups and places towards light industry products as well as the upgrade and replacement demand provide the industry with huge development opportunities.*
>
> *New types of urbanisation as well as changes in the demographic structures encompass demand potential. With the fostering of new types of urbanisation, urbanisation will release its huge domestic demand potential which will provide the light industry's sustainable and sound development with a strong boost. China*

[1602] Ibid., Section I.1.1.
[1603] Ibid., Section I.1.3.
[1604] Ibid., Section I.1.5.
[1605] Ibid., Section II.1.
[1606] Ibid., Section II.2.

> *shall further improve its demographic development strategy, ensure the full implementation of two-children policy, actively develop responses to the ageing population, and ensure the development of baby supplies' and elderly supplies' manufacturing.*[1607]

There are multiple provisions in the Plan on demands for structural optimization and value chain management, requiring the relevant parties, for example, to '*consider the further structural adjustments as a key task, to foster a coordinated development of an efficient supply of mid-high-end products, of large, medium and small-sized enterprises, of the upstream, mid-stream and downstream links of the industry chain, of the relative weight of the eastern, central and western industry areas, [and] engage on the development path based on improved quality and increased efficiency*'[1608] or '*guide large enterprises as well as medium and small-sized enterprises using various types of methods such as specific labour division, service outsourcing, made-to-order production, and establish collaborative relationships for collaborative innovation and win-win cooperation.*'[1609]

To accompany the process, the State intervenes by fixing specific production objectives: '*Production shall keep a stable and relatively quick growth. Over the 13th FYP period of time, the light industry's average annual growth in added value shall reach 6-7%, the allocation of production factors shall be further optimized, the industry chain's support and cooperation capacity shall be enhanced*'.[1610]

Beyond domestic markets, Chinese authorities also aim at influencing the foreign operations of Chinese companies, notably their exports patterns: '*Further raise international competitiveness. Optimize the export product structure, [and] strive to raise the share of electro-mechanical products and of general trade, foster new export competitive advantages, and strive to maintain the favourable position of the light industry in terms of market shares on the international market.*'[1611] In addition they also seek to influence their production and investment plans:

> *Speed up the fostering of technology, brands, quality and services so as to develop new core competitiveness advantages,[and] consolidate traditional international markets such as the American, European and Japanese markets. Combine the implementation of the* '*Belt and Road*' *strategy with the international cooperation requirements, [and] actively conquer new and emerging markets such as the Middle-East, Russia, Africa, Europe, South-East Asia, West-Asia, South-America, Central-America, etc.*'; '*strengthen the international production capacity*

[1607] Ibid., Sections I.2 and III.6.1.
[1608] Ibid., Section II.2.
[1609] Ibid., Section III.4.1.
[1610] Ibid., Section II.3.
[1611] Ibid., Section II.3.

cooperation, support brand enterprises to '*reach out*' [to foreign markets], *set up logistics centres and distribution centres in major sales markets, establish economic cooperation zones with eligible countries or regions. Support the setting up of foreign trade specific markets, set up border trade specific markets for light industry products with South-East Asia, Central Asia, Northeast Asia, etc.*[1612]

The Plan then goes on enumerating the key tasks for industry and the State administration. First, in a general manner, and in line with the overall supply management doctrine, it stresses the need, among others, to '*effectively raise supply capacities […]*'. Beyond that, the State will also '*support key industries and key industry chain links so as to promote technological transformation*' and '*guide enterprises to make sure they adopt advanced application technologies, [and] ensure the comprehensive improvement of manufacturing, processes and management*'. More specifically, the Plan puts an emphasises on supporting light industry enterprises in achieving international competitiveness, including in the ceramic sector: '*implement fine product manufacturing, [and] when basic conditions are relatively good, when there are enterprises as main actors with a certain brand reputation and international competitiveness, implement fine product manufacturing projects'*.[1613]

In a straightforward manner, the Plan sets out key guidance on managing the production patterns, requiring, for example, to '*strengthen light industry's fundamental capacities*' but also '*speed up R&D as well as industrialisation of key core technologies, […] speed up the transfer, dissemination and application of results*',[1614] while also '*strictly control[ing] the transfer of high-energy-consuming, high-emission, obsolete production capacities towards the Central and Western regions*'.[1615]

The Plan makes direct references to the need for managing supply in order to meet demand and vice-versa: '*Actively expand the domestic market. Follow the development trend of China's new urbanisation models, raise the level of effective supply of light industry products, [to] meet the customised and diversified upgraded consumption demand, foster overseas consumption backflow'*[1616] and '*conquer rural consumer markets, expand the light industry production of support products related to the development of new rural areas, to post-disaster*

[1612] Ibid., Section III.6.2.
[1613] Ibid., Section III.1.2.
[1614] Ibid., Section III.2.2.
[1615] Ibid., Box 7.
[1616] The following source explains the concept of *'overseas consumption backflow'*:
'MOFCOM will continue to work with the relevant departments to study and analyse some related policy issues, take targeted policy measures, make efforts to enable Chinese to buy high-end consumer goods at reasonable prices within China, further lead the overseas consumption backflow, stabilize and expand domestic consumption'. Account of the Regular Press Conference of MOFCOM on 31 March 2015. http://english.mofcom.gov.cn/article/newsrelease/press/201504/20150400932193.shtml (accessed on 16 October 2017). To be noted is MOFCOM's intention to *'take targeted policy measures'* in order to influence prices and consumption.

reconstruction, to rural infrastructures, etc.'[1617] In that, the Plan directs companies to pursue their business actively through marketing events in order for certain goods to be produced and purchased: '*encourage eligible cities to use market tools and consider activities such as fairs, shopping festivals, animation festivals, major contests as a means to foster production and consumption of light industry related products.*'[1618]

The Plan also entrusts its addressees with tasks related to specific industries. For the ceramic and enamel sector, it stipulates a range of very detailed provisions on product development:

> *Ceramic industry:*
>
> - *Boost the development of the ceramic industry's household products towards low-energy consumption, automation, information technologies;*
> - *expand new technologies such as highly efficient, energy-saving advanced moulding technologies for household ceramic products, high-speed firing technologies etc.;*
> - *develop in priority low-resource consuming products such as high-grade bone porcelain, high-quartz porcelain, talc porcelain, high feldspar porcelain, and green household ceramic products without heavy metal dissolution.;*
> - *strengthen the enterprises capacities for production innovation and design,*
> - *raise the products' added value;*
> - *strengthen the legacy and development of the artistic ceramics' traditional techniques;*
> - *develop in priority artistic ceramic fine products;*
> - *develop in priority high-purity, ultra-fine ceramic materials with outstanding performances such as high-strength, high-resistance, high-temperature proof, corrosion-proof, thermal-shock-proof, molten-metal-proof etc, high-performance ceramic heat exchange materials, high-performance new ceramic membrane materials, high-quality household ceramic materials;*
> - *speed up R&D on the low-temperature formulation systems;*
> - *reduce the products' firing temperature and energy consumption;*
> - *improve waste recycling and use;*
> - *strengthen clean production.*[1619]
>
> *Enamel industry:*
>
> - *Promote the development of the enamel industry towards functional innovation, health and environment protection, ecological applications;*

[1617] 13th Light Industry Development Plan, Section III.6.1.
[1618] Ibid.
[1619] Ibid., Section IV.1.8.

- *speed up enamel and glazing technological R&D and applications as regards anti-corrosion, new functional surfaces, high heat-resistance;*
- *foster industrialisation of enamel electrostatic dry powder and of enamel pre-grinding powder;*
- *develop in priority high-grade household enamel products as well as supporting enamel products related to household appliances and hardware products;*
- *expand supporting applications of enamel pots, enamel tanks for liquids, as well as construction and ornamental flat enamels;*
- *support enterprises to transform enamel and glazing production automation equipment and environmental protection facilities.*[1620]

The Plan also specifies which types of technologies should be qualified as being covered by R&D and industrialization projects,[1621] which types of products should be qualified as new materials engineering goods,[1622] and which types of equipment should be regarded as key manufacturing equipment.[1623]

Policy measures

As in the case of other key planning documents, the 13th FYP for the Light Industry stipulates a toolbox of measures to implement the policy aims and provisions. Below is a description of some specific examples:

The Plan notably refers to instruments aiming at managing market entry – notably by restricting investments in certain sectors: '*The State Council shall, in the form of a list, clearly set out the industries, fields, business sectors in which investment operations are prohibited or restricted. Outside of this list, any market actor may enter the market on an equal basis, in accordance with law.*'[1624]

The Plan also orders the increased use of support measures of a fiscal nature, notably by '*support[ing] the establishment of research and innovation platforms for key industries' new materials, core technologies, key-components, high-end equipment, etc. and increase the*

[1620] Ibid., Section IV.1.12.
[1621] Ibid., Box 2: '*Ceramics and enamels: key technologies related to high-quality household ceramic products, materials and technologies related to low-temperature sintered and high-quality household and sanitary ceramics, enamel pre-grinding powder manufacturing technologies, enamel electrostatic powder manufacturing technologies.*'
[1622] Ibid., Box 3: '*Ceramic industry's roller kilns using high-performance new ceramic rollers, materials used for pressure grouting forming, high-hardness-resistant glazing materials, high-performance new membrane materials, high-quality household ceramic materials.*'
[1623] Ibid., Box 5: '*Ceramics machinery: Fusion machines and ceramic process technologies, automation integrating machinery, electronics, hydraulics, IT and other high technologies, equipment ensuring IT-driven and smart moulding, glazing, sorting, decorating, model production, etc.*'
[1624] Ibid., Section V.1.

fundamental capacity for industry development'; '*supporting the improvement of traditional industry manufacturing as well as the development and deployment of new emerging industries, [and] guide enterprises so that they focus on technological transformation related to product optimisation, quality improvement, equipment modernisation, […]*' and '*implement[ing] relevant tax preferential policies, reduce enterprises' costs and expenses related to insurance and funds contributions*[1625] *and reasonably adjust consumption tax policy*.'[1626] The latter presupposes therefore market-distorting direct State-backed cost relief for enterprises.

One of the instruments foreseen is to '*make full use of the driving force of the National Fund for small and medium sized enterprises to boost SME's investments*' which would support not only technological innovation, but also structural adjustments. SMEs should be the object of '*various preferential policies*'.[1627]

The State moreover requires that companies are disciplined in their amortisation strategies by '*firmly implement[ing] quicker fixed asset depreciation policies so as to push enterprises to invest more in advanced equipment*'.[1628]

Another type of provision sanctioned by the Plan is the expanded use of financial support measures of various types by means of '*supporting SMEs' development, further expand[ing] SMEs' funding channels; improv[ing] credit insurance systems for SMEs*; *[…]*'; '*increase[ing] financial support to enterprises for technological reform and equipment modernisation*.'[1629]

The Plan also endorses interventions of the banking sector in support of light industries in '*the development of light industry product trademarks by developing loans mortgaged on enterprises' intangible assets such as their own brand or trademark rights etc. […]*'[1630] and in the increased '*support to export credit insurance for enterprises having developed their own brand.*'[1631]

Likewise, the document puts into the limelight the key role of industry associations as entities having a special relation with both State and industry: '*fully involve industry associations in their role as a bridge and a link between government and enterprise'*. This special character transpires through the provisions to '*support industry associations' efforts to deepen reforms, improve internal governance, raise capacities to serve the industry's development, strengthen investigation and research as regards the main problems related to the industry's*

[1625] 'Insurance and funds contributions' is meant as: pension insurance, maternity insurance, medical insurance, professional injury insurance, unemployment insurance and Providence Housing Fund.
[1626] 13th Light Industry Development Plan, Section V.3.
[1627] Ibid., Section V.3.
[1628] Ibid.
[1629] Ibid., Section V.4.
[1630] Ibid.
[1631] Ibid.

development, reflecting enterprises' concerns, guide and standardise enterprises' behaviour, strengthen the industry's self-discipline.'[1632]

Ultimately, the Plan makes clear to industry and all administrative levels that they should '*pay close attention to the coherence of the drawing up and planning of the implementation plan, implement relevant supporting policies, and ensure information feedback*' and underscores again the special overseeing role of Industry associations to '*guide and encourage enterprises to actively implement the planned and determined key tasks'.*[1633]

17.3.5. LOCAL PLANS

The degree and the depth of market management by State authorities down to the very local level can be shown using the example of the City of Chaozhou, in Guangdong Province. Chaozhou is an important manufacturing base for the Chinese ceramic sector, being the country's lead producer of daily-use ceramics, sanitaryware and electronic ceramics. Chaozhou is home to more than 10 000 ceramics manufacturers, which generate about one third of the city's value added output.[1634]

The local sector is regulated at the municipal level through various sub-central instruments, which in turn follow national planning provisions. Two of these instruments, the 13th FYP for the Economic and Social Development of the City of Chaozhou[1635] (hereafter 'the City Plan') and the Roadmap and Action Plan of the City of Chaozhou for the Transformation and Technological Upgrading of the Ceramic sector (2016-2018)[1636] (hereafter 'the Action Plan') are briefly described below.

17.3.5.1. 13TH FYP FOR THE ECONOMIC AND SOCIAL DEVELOPMENT OF THE CITY OF CHAOZHOU

The City Plan provides instructions on the management of the local industrial fabric. As in the case of other local planning documents, it follows the spirit of acts of higher governmental bodies: the central Chinese 13th FYP's '*national industry policy orientations*' and '*Guangdong's arrangements for the development of new and emerging industries*'.[1637] The ceramic sector is covered by the City Plan as one of the eight pillar sectors of Chaozhou:

[1632] Ibid., Section V.9.
[1633] Ibid., Section VI.
[1634] Website of the People's Government of Chaozhou City. http://www.chaozhou.gov.cn
[1635] http://www.chaozhou.gov.cn/u/cms/www/201611/16100656kgdl.pdf
[1636] Circular of the General Office of the People's Government of Chaozhou City on publishing the Roadmap and Action Plan of Chaozhou City for the Transformation and Technological Upgrading of the Ceramic Sector (2016-2018), Chao Fu Ban No. 47 (2016), 19 October 2016.
[1637] See 13th FYP for the Economic and Social Development of the City of Chaozhou. Section II.3.4.

‘'*keep expanding the clusters for the eight specific pillar industries: i.e. ceramics,* […]’.[1638] The City Plan contains specific provisions on the development of the sector.

First and foremost, it directs the city to *‘strongly promote the industry transformation and upgrade’*. In that respect, the authorities are to support ‘*the high-end development, the scaling up, the emergence of an industry chain, the development of brands in the 8 pillar industries [and] guide the ceramic industry […] towards a refined division of labour and close cooperation between enterprises towards development*’.[1639] In that respect, the Plan promises to *‘support and foster […] backbone enterprises with relatively strong indigenous innovation capacities and a science and technology driving role’*. At the same time, the local government is to intervene and *‘improve the policy environment as regards fiscal and tax incentives, investment and funding mechanisms, [...] [and] actively foster strategic and emerging industries.’*[1640]

As in the case of other sub-central level planning documents, the Plan goes in depth with specific technical provisions, e.g. requiring relevant parties to *‘use advanced applied technologies to transform and upgrade Chaozhou's specific competitive industries and agriculture, such as ceramics[…]’*, ‘*actively promote smart production robotics and automated moulding equipment in the ceramic industry*’[1641] or to implement certain key projects such as ‘*the transformation and upgrading of high end ceramics production lines as well as the application of efficient technologies for tunnel kilns’*.[1642]

In terms of implementation measures, the City Plan emphasises the government's leading function in controlling the path of development and transformation: ‘*better use the government's macro-control role so as to reform and ensure development promotion, changes in methods, structural adjustments, [...]’*.[1643]

It requires relevant parties to *‘complete the Plan's implementation mechanisms; fully use the Plan's guiding function as regards resource allocation, actively explore management based on* ‘*the convergence of multiple plans*’ *and* ‘*single map*’*-based management; and strengthen monitoring and supervision so as to ensure the effective implementation of the Plan*’,[1644] while at the same time the document stipulates the need to *‘strengthen governmental guidance, set out yearly Plan's implementation plans, [and] set up long-term mechanisms to safeguard the Plan's implementation.*’[1645] Regarding the latter, the Plan specifies in detail what implementation should look like:

[1638] Ibid., Section I.1.1.
[1639] Ibid., Section II.3.1.
[1640] Ibid., Section II.3.4.
[1641] Ibid., Section II.2.2.
[1642] Ibid., Box 3.
[1643] Ibid., Section II.1.
[1644] Ibid., Section III.
[1645] Ibid., Section III.1.

> *In accordance with the development objectives and major tasks set out in the Plan, all administrations at all levels shall develop a Plan's yearly implementation plan detailing work distribution, clarifying work responsibilities as well as implementing objectives and tasks year by year and item by item; […] Consider the target-related shortcomings and task-related weaknesses spotted in the course of the Plan's implementation as the yearly priorities to foster further work; […] Strengthen convergence and coordination of the yearly implementation plans with the yearly programming.*[1646]

The binding character of the City Plan's provisions is further emphasised: '*Strengthen the targets' binding effect: [by] mak[ing] subject all areas and all sectors of the economic and social development's comprehensive evaluation system to binding objectives set out in the Plan.'*[1647] The Plan also contains, like virtually all planning documents, provisions aiming at strengthening monitoring and evaluation, involving even the population: '*improve the mechanisms ensuring public participation and citizens' supervision of the Plan's implementation'; 'complete yearly evaluations and mid-term reviews, examine the Plan's implementation situation, analyse the Plan's implementation results, identify and solve problems in due time.'*[1648]

17.3.5.2. The Roadmap and Action Plan of the City of Chaozhou for the Transformation and Technological Upgrading of the Ceramic sector

The provisions of the 13th Five-Year City Plan are accompanied by a dedicated development programme for the local ceramic industry adopted in 2016 and valid for the period 2016-2018. The Roadmap and Action Plan of the City of Chaozhou for the Transformation and Technological Upgrading of the Ceramic Sector specifies in detail the way the municipal authorities plan the sector to develop. While the Action Plan acknowledges the success of Chaozhou's ceramic enterprises (the city is one of the country's most dynamic and fastest growing producing areas, value chains are fully integrated, energy consumption has been curbed),[1649] the local government makes clear that the sector still needs guidance and control through various means. Notably, it requires that by the end of 2018 specific changes are brought to the industrial structure and the product portfolio of companies. The industry is also to undergo important transformation in terms of technological upgrades.[1650]

[1646] Ibid., Section III.1.3.
[1647] Ibid., Section III.3.1.
[1648] Ibid., Sections III.3.1 and III.3.2.
[1649] Roadmap and Action Plan of Chaozhou City for the Transformation and Technological Upgrading of the Ceramic Sector (2016-2018). Section I.1.
[1650] Ibid., Section II.

The industrial layout is to be further steered into optimisation through the concentration of the industry, and to that end the government promises support to a range of larger competitive flagship companies.[1651] The latter, also called 'backbone' companies, will benefit from a '*one company – one policy*' and '*one company – one law*' approach from the government, which translates into tailored-made policies for each such enterprise, including State support.[1652] The Action Plan notably directs the build-up of these leading companies through cross-regional mergers and acquisitions.[1653]

With respect to that, Chaozhou is supposed by 2018 to achieve the goal of having at least five producers with an annual output value of more than RMB 500 million.[1654]

The authorities will also promote growth by supporting enterprises in obtaining capital via the stock market. The city is supposed by 2018 to lead at least ten companies to stock market listings, which will result in being covered by special support and assistance policies.[1655]

Innovation policy is also not left fully to the discretion of the enterprises, as the Action Plan establishes very specific targets to be fulfilled in terms of technological development and product mix: by the end of the planning period at least 10% of large enterprises will have to be considered as using high technology, while the share of newly introduced products will have to account for at least 10% of the turnover. The City is also supposed to attract the establishment of a certain number of provincial-level technological centres.[1656]

The Action Plan also requires changes in production processes, establishing that no less than 10% of local companies have to carry out the mechanisation and automation of their manufacturing lines in order to keep the lead of the national industry, while those which use half-automatized production methods should gradually switch to full automation.[1657]

Finally, the Action Plan lays out support measures for the local ceramic industry. It grants producers the possibility to reduce their running costs through a special risk compensation fund. The City's commercial banks are to cooperate in this process. The Plan's provisions also allow for this cooperation mechanism to benefit companies with financing difficulties.[1658] In that framework, the city's authorities also commit to establish a special company to guarantee commercial banks loans for distressed companies.[1659]

[1651] Ibid., Sections II.1 and III.3.2.
[1652] Ibid., Section III.3.1.
[1653] Ibid., Section III.3.2.
[1654] Ibid., Section II.1.
[1655] Ibid. See also Section III.3.2.
[1656] Ibid., Sections II.2 and III.1.1.
[1657] Ibid., Section II.3. See also Sections III.1.3 and III.2.1.
[1658] Ibid., Section III.4.3.
[1659] Ibid., Section III.4.3.

As in other planning documents, in the Action Plan the government undertakes to make use, at all levels, of all available support measures, including fiscal and taxation tools to implement the Plan's provisions.[1660]

Furthermore, this implementation will be planned, coordinated and overseen by a special working group led by a vice mayor. This mechanism involving a senior official proves how far the State is influencing the management of industrial matters with a direct impact on production patterns and the cost structures of companies.[1661]

17.4. STATE SUPPORT MEASURES

As demonstrated above, the planning documents governing the ceramic sector in China allow for broad financial support of Chinese producers, in order to accompany the implementation of various plans. The ceramic industry, like many others has benefited from numerous schemes related to various fields of activity.

Certain provinces maintain schemes to support the commercialization of R&D and patents. This is for example the case of Guangdong Province, where the basis for such subsidies is the Plan for Patent Technology Transformation and Implementation.[1662] According to the Guangdong Provincial Intellectual Property Office certain ceramics manufacturers have benefitted in 2016 from patent-related financial transfers.[1663]

Specific funds also allegedly serve to compensate the financial losses of companies whose products are subject to trade defence measures. Guangdong Province's Special Fund for Promoting Import and Export Fair Trade is an example thereof.[1664]

In addition, as specified above (see Section 17.3.5.2), ceramic companies can be rewarded financially for achieving a listing on the stock market.

Certain schemes accompany the process of upgrading and technological readjustment, imposed by the plans at various levels. One of the schemes to that effect is the Special Work Programme for Industrial Rejuvenation and Technological Transformation, updated in 2015 by NDRC and MIIT.[1665] Under the latter, allocations are made to cover, among others, the

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[1660] Ibid., Section III.4.4.
[1661] Ibid., Section IV.1.
[1662] Notice of the Guangdong Intellectual Property Office on the Plan for Patent Technology Transformation and Implementation in 2016, Guangdong Intellectual Property Office, no 97, 6 May 2016 (available at: http://www.gdipo.gov.cn/shared/news_content.aspx?news_id=12293).
[1663] Notice of the Guangdong Intellectual Property Office on the Plan for Patent Technology Transformation and Implementation in 2016, Attachment 1, Guangdong Intellectual Property Office, 6 May 2016, available at: http://www.gdipo.gov.cn/shared/news_content.aspx?news_id=12293 (accessed on 16 October 2017).
[1664] Guangdong Province measures for the Administration of a Special Fund for Promoting Import and Export Fair Trade. Yue Cai Wai [2014] no. 91, 1 July 2014.
[1665] The Special Work Programme for Industrial Rejuvenation and Technological Transformation (国家发展改革委办公厅 工业和信息化部办公厅关于做好 2015 年产业振兴和技术改造专项有关工作的通知), updated in 2015 by the NDRC and MIIT. http://fgw.nc.gov.cn/News.shtml?p5=3579967 (accessed on 16 October 2017).

costs of industrialization of key technologies, of upgrading of infrastructure and of transformation of production processes. Projects benefitting from the scheme have to fulfil the requirements of overall industrial policy and regional development policy considerations.

Other reported schemes take the form of incentives for the use of credits provided by the state-owned China Export & Credit Insurance Corporation.[1666] In relation to this, export performance can also be rewarded.

Tax incentives

Under the VAT rebate policy, Chinese exporters of ceramic tiles can benefit from a 9% VAT rebate,[1667] while exporters of kitchen and tableware benefit from a 13% rebate.[1668] As specified in this Report already, China has been using such rebates to intervene in the market with the aim to achieve industry policy objectives.

Examples of financial support

Based on materials made available to the Commission, a certain number of ceramic producers have benefited from schemes such as the ones described above. As mentioned, support measures have been, for example, enshrined in the planning measures of the City of Chaozhou. One of the beneficiaries of numerous subsidies is allegedly a (listed) company active in that city. The latter company benefited in the period of 2013-2017 from allocations of at least RMB 1 million from each of the following schemes:

- An allocation from the first batch of the 2015 Enterprise R&D Support Fund of the Guangdong Province,[1669]
- An allocation from the second batch of the 2015 Technology Renovation Fund,[1670]

[1666] Guangdong Administrative Measures for the Special Fund for Promoting the Use of Export Credit Insurance (广东省促进投保出口信用保险专项资金管理办法), Guangdong Department of Commerce, Guangdong Department of Finance, 5 May 2014. http://zwgk.gd.gov.cn/006939991/201406/t20140617_532789.html (accessed on 16 October 2017).
[1667] See Lehman Brown: *China Increases the Export Value-Added Tax Refund Rates for Textile Products, Certain Electronic Products and Other Commodities.* http://www.lehmanbrown.com/insights-newsletter/china-increases-export-value-added-tax-refund-rates-textile-products-certain-electronic-products-commodities/ (accessed on 13 December 2017). See also the Notice of China's Ministry of Finance and the State Administration of Taxation, Caishui [2009] No. 43 of 27 March 2009. http://www.chinatax.gov.cn/n810341/n810765/n812166/n812647/c1189479/content.html (accessed on 16 October 2017).
[1668] See the Export Tax Rebate Rates list of the China's State Authority for Taxation: pp. 418-419. http://hd.chinatax.gov.cn/fagui/action/InitChukou.do (accessed on 16 October 2017).
[1669] Opinions of Guangdong Provincial People's Government on Promoting Scientific and Technological Innovation (广东省人民政府关于加快科技创新的若干政策意见), Article 1, Guangdong Provincial People's Government, 15 February 2015. http://zwgk.gd.gov.cn/006939801/201509/t20150924_621298.html?keywords= (accessed on 16 October 2017).
[1670] Ibid., Article 2.

- Rewards for completed technology renovation projects at industrial enterprises of Chaozhou City in 2015,
- Support for the development and commercialization of high performance optical fibre high-speed connector materials,
- Support for the commercialization of ceramic package substrate for application in new-type electronic components,
- Support for R&D on and the commercialization of porcelain cement for application in large capacity BME-MLCC,
- Support for technology commercialization in the field of ceramic package substrate for LED application,
- Support for the commercialization of aluminium nitride plates for application in electric and electronic components,
- Allocation from the 2013 and 2016 Central Government Fund for the Promotion of Foreign Trade for the Cultivation of Corporate Brands,[1671]
- Allocations from the Government-Bank-Enterprise-Cooperation Fund for supporting Strategic Emerging Industries and loan interest subsidies,[1672]
- A reward for going public (IPO),[1673]
- Allocations from Industry development funds.[1674]

As another example, a ceramics company from Hebei Province also benefited from certain schemes, in total amounts of more than RMB 1 million per scheme in the same period:

- Support for the commercialisation of fine sanitary ceramic products,

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[1671] Notice on Issuing the Guide for Applying for Central Government's Special Fund for Development of Foreign Trade in 2016 (关于印发《中央财政 2016 年度外经贸发展专项资金（外贸中小企业开拓市场、企业品牌培育项目）申报指南》的通知), Guangdong Department of Commerce, Guangdong Department of Finance, 2 September 2016. http://zwgk.gd.gov.cn/006939780/201704/t20170427_703493.html.
[1672] Detailed Rules for the Follow-up Management of Government-Bank-Enterprise-Cooperation Special Funds for Strategic Emerging Industries of Guangdong Province (广东省战略性新兴产业政银企合作专项资金项目后续管理工作实施细则), Guangdong Economic & Information Commission, Guangdong Department of Finance, 14 November 2012. http://www.gdei.gov.cn/ywfl/jscx/201507/t20150708_117348.htm (accessed on 16 October 2017).
[1673] Policies and Measures for Reducing the Cost of Manufacturing Enterprises and Supporting the Development of Real Economy (广东省降低制造业企业成本支持实体经济发展若干政策措施), Article 6, People's Government of Guangdong Province, 20 August 2017. http://www.gdczt.gov.cn/zwgk/czxw/201708/t20170825_884703.htm (accessed on 16 October 2017).
[1674] Support measures and funds in Guangdong are published on Guangdong Online Business Hall. http://210.76.70.125:7009/SpecialWeb/outer/showOutIfnoPageNew

- Support for export credit insurance,
- Refunds of land use fees and compensation for infrastructure construction expenses,
- A reward for going public (IPO),
- Several support measures for employment stabilisation,
- Several support measures for the construction of staff housing.[1675]

17.5. GOVERNMENT INTERVENTIONS DISTORTING THE CERAMICS MARKET AS FOUND IN TRADE DEFENCE PROCEEDINGS

The significant overcapacity in the Chinese ceramic sector and a slower development of domestic demand in China has led Chinese producers to focus increasingly on export markets. Today, a number of countries either initiated trade defence investigations or already adopted trade defence measures against ceramic tiles originating in China.

Among countries outside the EU, Thailand imposed an anti-dumping duty of 2.18-35.49% on Chinese tiles in 2011.[1676] Argentina[1677] and Brazil[1678] imposed specific duties of USD 50.03/m^2 and from USD 3.34/m^2 to USD 6.42/m^2 respectively in 2014. South Korea's duty against Chinese tile imports, ranging from 9.07% to 37.40%, became applicable in 2015.[1679] Meanwhile, other countries such as India, Pakistan, Colombia and Mexico have initiated investigations, which are still ongoing, and will likely lead to similar trade measures.[1680]

[1675] Provincial-level support measures and funds in Hebei are published on the official website of Hebei Financial Department: http://www.hebcz.gov.cn/szzt/zxzyzf/ (accessed on 16 October 2017).
[1676] Semi Annual report notified by Thailand (WTO Document G/ADP/N/280/THA of 20 January 2016). https://docs.wto.org/dol2fe/Pages/FE_Search/FE_S_S009-DP.aspx?language=E&CatalogueIdList=226351,134701,130202,127234,123869,119538,115797,50955,100304,56482&CurrentCatalogueIdIndex=0&FullTextHash= (accessed on 16 October 2017).
[1677] Semi Annual report notified by Argentina (WTO Document G/ADP/N/280/ARG of 18 March 2016). https://docs.wto.org/dol2fe/Pages/FE_Search/FE_S_S009-DP.aspx?language=E&CatalogueIdList=227603,135091,130979,127415,122681,119257,115967,32433,85321,109779&CurrentCatalogueIdIndex=0&FullTextHash= (accessed on 16 October 2017).
[1678] Semi Annual report notified by Brazil (WTO Document G/ADP/N/280/BRA of 25 February 2016). https://docs.wto.org/dol2fe/Pages/FE_Search/FE_S_S009-DP.aspx?language=E&CatalogueIdList=227972,227122,225936,134855,131490,128532,127901,127171,127059,127071&CurrentCatalogueIdIndex=1&FullTextHash= (accessed on 16 October 2017).
[1679] Semi Annual report end 2015 notified by Republic of Korea (WTO Document G/ADP/N/272/KOR of 19 October 2015). https://docs.wto.org/dol2fe/Pages/FE_Search/FE_S_S009-DP.aspx?language=E&CatalogueIdList=227964,135247,130271,126948,122940,118559,114660,101375,86881,45498&CurrentCatalogueIdIndex=1&FullTextHash= (accessed on 16 October 2017).
[1680] Semi Annual report notified by Colombia (WTO Document G/ADP/N/280/COL of 21 March 2016), Semi Annual report notified by Mexico (WTO Document G/ADP/N/280/MEX of 22 February 2016), Notification under article 12.1(a) of the agreement on safeguards on initiation of an investigation (WTO Document G/SG/N/6/TUN/5 of 30 July 2015).

In the EU, several anti-dumping investigations imposed definitive measures on imports of ceramic goods originating in China: ceramic tiles and ceramic tableware and kitchenware. In both cases, market distortions were found.

17.5.1. CERAMIC TILES CASES

In September 2011, the Council imposed a definitive anti-dumping duty on imports of ceramic tiles originating in China by Implementing Regulation (EU) No 917/2011.[1681] The duty levels applied ranged from 13.9% to 69.7%.[1682] On 13 September 2016, the Commission initiated an expiry review of the measures. Further to the latter, the range of duty levels has been upheld.[1683]

The initial investigation established that the business licence of a group of exporting producers encompassed an export sales restriction, which was found to be applied in practice. It was therefore considered that sales decisions were not taken freely but were subject to significant State interference.[1684] Moreover, the investigation revealed that assets were not being correctly recorded in the companies' accounts and that the Chinese producers were not able to demonstrate that they had paid for their land use rights.[1685] The latter element points to the fact that the Chinese State could interfere in the ceramic tiles market by granting land use rights to domestic producers at lower cost or no expense.

Additionally, it was found that two groups of producers were not able to demonstrate the origin of the initial capital used in the companies' establishment, which could point to another market intervention of the State in the form of financial injections into the capital of the Chinese companies.

[1681] Council Implementing Regulation (EU) No 917/2011 of 12 September 2011 imposing a definitive anti-dumping duty and collecting definitively the provisional duty imposed on imports of ceramic tiles originating in the People's Republic of China (OJ L 238, 15.9.2011).
[1682] OJ C 336, 13.9.2016, p.5.
[1683] Commission Implementing Regulation (EU) No 2017/2179 of 22 November 2017 imposing a definitive anti-dumping duty on imports of ceramic tiles originating in the People's Republic of China following an expiry review pursuant to Article 11(2) of Regulation (EU) 2016/1036 of the European Parliament and of the Council (OJ L 307, 23.11.2017, p. 25).
[1684] Council Implementing Regulation (EU) No 917/2011 of 12 September 2011 imposing a definitive anti-dumping duty and collecting definitively the provisional duty imposed on imports of ceramic tiles originating in the People's Republic of China (OJ L 238, 15.9.2011, p. 9).
[1685] Ibid., p. 9.

17.5.2. CERAMIC TABLEWARE AND KITCHENWARE CASE

In May 2013 the Council imposed a definitive anti-dumping duty on imports into the Union of ceramic tableware and kitchenware originating in China with Implementing Regulation (EU) No 412/2013.[1686] The currently applicable duty levels range from 13.1% to 36.1%.[1687]

State intervention was found to exist with regard to purchases of land use rights, purchases of raw materials and with regard to a company's recruitment process, which demonstrates that business decisions were not made in response to market signals, without State interference and that costs did not reflect market values.[1688]

17.6. CHAPTER SUMMARY

The ceramic sector is a traditional sector of the Chinese industry. Due to its labour-intensive character and historic meaning, the State has been closely overseeing, steering and managing its development. As in the case of other key sectors, this State involvement is visible through the ladder of planning documents issued at all levels – from national to municipal. The government's intervention into the ceramic sector aims, among others, at managing the overblown production capacity of certain sub-sectors, which is the actual result of past interventions. Another important vision that the Chinese State pushes for is the concentration of the rather fragmented ceramic industrial tissue. This often translates into government requirements to develop large competitive conglomerates. Such consolidation would also allow greater control of the sector in order to implement government policies.

The Chinese ceramic sector is also subject to a plethora of provisions aiming at transforming its production structure and geographical layout, at managing the supply and demand side of the business and at steering product development towards a more value-added portfolio. Enterprises are directed to 'reach out' for foreign sales markets.

All these aims are achieved through the imposition of specific targets or indicators (even growth or production-related) and policy requirements, while virtually all the planning tools also set out specific implementation and monitoring measures.

Finally, all the processes described above are openly supported by the State, in the form of innovation funds, preferential loans, export incentives, financial transfers, tax relieves, land-use cost relief and employment-stabilisation schemes, etc. These policies, and the support

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[1686] Council Implementing Regulation (EU) No 412/2013 of 13 May 2013 imposing a definitive anti-dumping duty and collecting definitively the provisional duty imposed on imports of ceramic tableware and kitchenware originating in the People's Republic of China (OJ L 131, 15.5.2013).
[1687] Measures expire on 16 May 2018, unless an interim review is initiated before.
[1688] Council Implementing Regulation (EU) No 412/2013 of 13 May 2013 imposing a definitive anti-dumping duty and collecting definitively the provisional duty imposed on imports of ceramic tableware and kitchenware originating in the People's Republic of China (OJ L 131, 15.5.2013, p. 35, 36).

related to them have direct and indirect consequences on the cost structures of companies and product prices, leading to significant market distortions in the sector.

Table of abbreviations:

13FYP	13th Five-Year Plan
AIC	Administration of Industry and Commerce
AMC	Asset Management Company
AML	Anti-Monopoly Law of the People's Republic of China
BL	Tendering and Bidding Law
BRI	Belt and Road Initiative
CBRC	China Banking Regulatory Commission
CBSA	Canada Border Services Agency
CCP	Chinese Communist Party
CEFIC	European Chemical Industry Council
CIRC	China Insurance Regulatory Commission
CISA	China Iron and Steel Association
CPC	Centralised Procurement Catalogue
CPCIF	China Petroleum and Chemical Industry Federation
CSRC	China Securities Regulatory Commission
DRC	(local) Development Reform Commission
EJV	Equity Joint Ventures
EUCCC	European Union Chamber of Commerce in China
FIC	Foreign Investment Catalogue
FIE	Foreign-invested Enterprise
FYP	Five Year Plan
GDP	Gross Domestic Product
GEM	Growth Enterprises Market
GPA	Government Procurement Agreement
GPL	Government Procurement Law
HKSE	Hong Kong Stock Exchange
HRS	Household Responsibility System
IISD	International Institute for Sustainable Development
INE	Shanghai International Energy Exchange
IPR	Intellectual Property Rights
JV	Joint Venture
LME	London Metal Exchange
LTAR	Less Than Adequate Remuneration
MFA	Ministry of Foreign Affairs
MIIT	Ministry of Industry and Information Technology
MLR	Ministry of Land and Resources
MOF	Ministry of Finance
MOFCOM	Ministry of Commerce
MoHRSS	Ministry of Human Resources and Social Security
NAFMII	National Association of Financial Market Institutional Investors
NEA	National Energy Administration
NEV	New Energy Vehicles

NDRC	National Development and Reform Commission
NPC	National People's Congress
NPL	Non-Performing Loan
OECD	Organisation for Economic Cooperation and Development
OTC	Over-the-Counter
PBOC	People's Bank of China
PICC	People’s Insurance Company of China
POE	Privately-owned Enterprise
PORC	Public Offering Review Committee
PPP	Public-Private Partnership
PPT	Prescribed Procurement Thresholds
PRC	People's Republic of China
PV	Photovoltaics
QFII	Qualified Foreign Institutional Investors
SAFE	State Administration of Foreign Exchange
SAIC	State Administration of Industry and Commerce
SEI	Strategic Emerging Industries
SHFE	Shanghai Futures Exchange
SHSE	Shanghai Stock Exchange
SME	Small and Medium-Sized Enterprise
SOE	State-Owned Enterprise
SPC	Supreme People's Court
SSSR	Supply-Side Structural Reform
STE	State Trading Enterprise
SZSE	Shenzhen Stock Exchange
TDI	Trade Defence Instruments
UNIFE	The Association of the European Rail Industry
WMP	Wealth Management Product
WTO	World Trade Organisation