CHINA'S WTO ACCESSION AND THE SEMICONDUCTOR INDUSTRY

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-- Speaking Notes --

Thank you. My name is John Magnus. I am a Washington, DC-based trade law expert from the law firm Dewey Ballantine, and I have worked on WTO issues for many years. I am pleased to be here today to talk with you about how some of the key WTO rules will apply to China after accession. My talk will cover some of the primary WTO principles, such as tariff bindings and non-discrimination rules, as well as some more detailed issues of special importance to the semiconductor industry such as trading and distribution rights, purchasing policies of state-invested enterprises, and investment rules.

In each area, there are two main sources of obligations: (1) the basic WTO rules, and (2) China's accession package, whose commitments in some areas supplement the basic WTO rules. The accession package includes a Protocol of Accession, a Working Party Report, and the various schedules of commitments China has tabled in the market access negotiations.

(Intellectual property protection is also covered by the WTO rulebook and is of great importance to the semiconductor industry. However, I will not be covering that topic today, as I understand that it will be fully discussed later by others, including Jennifer Ness from the U.S. Patent and Trademark Office.)

I. GENERAL WTO PRINCIPLES

Tariff bindings: Probably the most basic WTO obligation is not to impose, on imported products, customs duties in excess of scheduled tariff bindings. This simple concept accounts for much of the success of the multilateral trading system in its first half-century.

China has made tariff commitments on thousands of items in the various chapters of the Harmonized Tariff Schedule. Of interest today, China has agreed to phase out, in accordance with the Information Technology Agreement, its tariffs on IT products such as semiconductors, semiconductor manufacturing equipment, computers, computer parts, software, and telecommunications equipment. The November 1999 U.S.-China bilateral understanding includes a pledge by China to implement the ITA fully by 2005. For semiconductors, China has committed to eliminate the existing 6-9% tariffs as of January 1, 2002.

It is in China's interest to adhere to the negotiated schedule, given that access to high-quality, low-cost semiconductors is critical to the development of a competitive electronics industry in China. Eliminating these tariffs will also provide a basis for the China Semiconductor Industry Association to join the World Semiconductor Council.

Moreover, China's exports will, of course, have the benefit of other WTO Members' tariff commitments.

Non-tariff measures: Also subject to scheduled elimination in the WTO system are other (non-tariff) measures that directly or indirectly limit imports. These can be border measures such as import quotas, or internal measures like licensing requirements. One example would be local content schemes in which manufacturers are pressured to source parts and materials domestically, thereby discouraging the purchase of imported components. Localization pressures result in a distortion of procurement and harm the competitiveness of China's domestic producers.

Non-discrimination: Articles I and III of the GATT set out rules of non-discrimination. Article I covers most-favored nation (MFN) treatment, and Article III covers national treatment.

The MFN obligation prohibits all Members, including China after accession, from favoring the products of one WTO Member over those of another, whether in the use of border measures like tariffs or of internal measures that affect imports. Every product imported by China from a WTO Member will be entitled to treatment “no less favorable” than the best treatment accorded to other like imports. China's products will likewise be entitled to MFN treatment in export markets around the world, including the United States (where we now refer to MFN as "normal trade relations" status).

While Article I addresses discrimination between imported products of different origins, Article III addresses discrimination between imported and domestic products. The "national treatment" obligation prohibits WTO Members, including China after accession, from favoring domestic products over imported ones, whether in the use of taxes or of other internal measures that affect the success of products in the market place. Every product imported by China from a WTO Member will be entitled to "treatment no less favorable" than the best treatment accorded to like or directly competitive domestic products. (One example relevant here is the June 2000 announcement by China's State Council that qualifying integrated circuit manufacturers would receive a rebate of VAT payments in excess of 6%, to be used for expanded production or R&D. Any VAT reduction should be administered on a national treatment basis, i.e., provided to all qualifying companies whether foreign or domestic.)

Transparency: A fourth category of basic WTO obligations involves transparency – keeping all market participants, including importers and foreign suppliers, fully apprised of the legal requirements that could affect their marketplace activities, and giving them the opportunity to comment as those requirements evolve.

This is covered generally by GATT Art. X and may require considerable procedural changes within China -- changes that will benefit Chinese economic development. An economy of China's size and complexity requires rules and procedures that are published regularly, and are not subject to differing interpretations by officials. One immediate step is to begin fully publishing all laws, regulations and decisions relating to trade and investment. China should move to a system featuring advance notice and comment on trade- and investment-related regulations, and ready availability of official interpretations (published judicial decisions and authoritative administrative statements). In the WTO accession talks, China has agreed to take such steps.

II. PURCHASING BY STATE-INVESTED ENTERPRISES

Turning now to some of the more detailed issues important to the semiconductor industry, one key item is the rules governing purchases by state-invested enterprises. "State-invested" means wholly or partially owned by the Chinese central, provincial or local governments. State-invested enterprises are especially prominent in the electronics sector.

Given the continuing active government role in the electronics sector as Chinese semiconductor production grows both in volume and quality, it is important that government officials refrain from steering state-invested enterprises toward purchasing locally-made goods. For the benefit of China's economic development and to avoid trade friction with trading partners, a key element is the pledge, in China's WTO accession package, that state-invested enterprises will make purchases based solely on commercial considerations, such as the price and quality of products, rather than on the basis of national origin. China has agreed that it will not influence these commercial decisions except in a WTO consistent manner. This is of course in China's own interest, as its state-invested companies should seek access to the highest quality and most affordable components in order to be competitive in world markets.

III. ELIMINATION OF INVESTMENT RESTRICTIONS

While China seeks to promote foreign direct investment, a number of complex requirements exist for foreign-owned ventures, including a restrictive approval and registration system and a number of official and informal "performance requirements," all of which tend to discourage foreign investors.

China has agreed that, upon accession, it will implement the WTO Agreement on Trade-Related Investment Measures (TRIMs), eliminate export performance and local content requirements on foreign investors, and only enforce laws related to the transfer of technology if they are in accordance with WTO rules. China also agreed that it will not condition investment or import approvals on performance requirements of any kind, including: local content requirements, offsets, transfer of technology, or requirements to conduct research and development in China. This means adhering to the following rules.

- *Export performance requirements*: Foreign companies can no longer be pressed by the Chinese approval authorities to agree to export targets, for example, to export 50% of production. Further, while 100% foreign ownership of manufacturing facilities is permitted in China, it appears that, under a policy applicable to the electronics industry, all of such a facility's output must normally be exported. Similarly, a 70/30 foreign majority-owned electronics joint venture is generally required under the same policy to export 70% of its production, but there are no uniform rules; each arrangement is negotiated on a project-specific basis. In one case, Chinese authorities reportedly removed the export requirement from a contract, on condition that the applicant, a U.S. firm, would re-invest in China all profits earned from domestic sales. Such arrangements would be contrary to China's WTO commitments.

- *Local content requirements*: There should no longer be localization policies for parts and materials for products made in China. These are not technically legal requirements, yet firms have had to file localization plans with their foreign investment applications. The Chinese Government also has audited foreign firms to determine local content, and has used inconsistent criteria in doing so. For example, importation via a Chinese distributor can sometimes qualify a part as "local." Sectoral industrial policies in China also contain local content requirements. These measures will no longer be permitted after WTO accession.

- *Technology transfer requirements*: Ownership restrictions, export targets and local content rules have in some cases functioned not as strict legal obligations, but as negotiating levers used by government officials at both the national and sub-national level seeking to obtain transfer of technology from foreign firms. This is no longer supposed to occur after WTO accession.

Individually and collectively, these kinds of measures have a significant adverse competitive impact. To the extent that China maintains such measures in the future, other countries would be permitted to limit access to their markets for China's electronics and semiconductor products. Investment restrictions also have a negative effect on China, as they discourage the foreign investment necessary to develop a local Chinese electronics industry on a commercially sound basis. For these reasons, WTO accession, while it does require significant changes from past practice in China, will be of great benefit.

IV. TRADING AND DISTRIBUTION RIGHTS

One of the most important changes in China's trade regime will be in the area of trading and distribution rights.

Distribution rights: The right to distribute and service goods within China will no longer be restricted, as China has agreed to phase in distribution rights within three years of accession. Foreign producers will be able distribute and provide after-sales service directly, increasing efficiency and removing as much as 10% in costs and adverse effects on service, inventory, and delivery. Inability to deal directly with end-users is a particular problem in the semiconductor industry, where the design and development of application-specific chips requires extensive contact between producers and end-users. It is important to China's development as an international competitor in electronics to move as quickly as possible to provide distribution rights to all firms, without discrimination on the basis of nationality or other factors.

Trading rights: Also important are trading rights -- the legal right to import and export goods. These rights have been limited to certain designated enterprises, including certain foreign-invested firms, which can trade products they manufacture in China. Foreign firms doing business in China without such rights have had to conduct their business through firms that hold such privileges. Moreover, a foreign company generally could not directly sell or service end products, spare parts or components not made in China. In the past, these limitations were significant impediments to foreign semiconductor firms' ability to serve their Chinese customers. China has committed to phase in trading rights for foreign firms (including semiconductor suppliers) within three years from accession. How this commitment is implemented will be important.

By increasing direct interaction between producers and buyers and reducing costs, the establishment of trading and distribution rights will decrease the opportunities and incentives to sell goods through indirect channels, including by smuggling. Another way to decrease cost incentives for indirect sales channels, including smuggling, would be a further reduction in the VAT for semiconductors.

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It has been a pleasure briefing you today, and I look forward to your questions.