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September 22, 2006

Re: Response to Bacchus/Shapiro Analysis of WTO-Consistency of Hunter-Ryan Bill (HR 1498)

A. Introduction

The following analysis is offered to provide a response to the September 12, 2006, memorandum prepared for NAM by James L. Bacchus and Ira Shapiro (hereinafter "Bacchus/Shapiro memo"). That memo concludes that the Chinese exchange rate regime is not a prohibited (or actionable) subsidy under the SCM Agreement and, therefore, H.R. 1498 (the Hunter-Ryan bill) is unlikely to be WTO-consistent at least as applied to China. The authors are well-known and well-regarded trade law practitioners, and their views on WTO matters should certainly be respected. However, reasonable minds may disagree about issues such as the WTO-consistency of proposed legislation where no directly similar measure has previously been considered by a WTO dispute settlement panel or the Appellate Body. In addition, the Bacchus/Shapiro memo recognizes the seriousness of the problem and does not suggest that nothing should be done to address it. Rather, they suggest that the chances of a successful offensive challenge to the Chinese currency regime based on a GATT 1994 Article XV:4 violation would be better than the chances of a successful defense of H.R. 1498 in a WTO dispute. The initiation of such an offensive challenge was, of course, the purpose of the Section 301 petition filed by the China Currency Coalition ("Section 301 petition"), which unfortunately was not accepted by the Administration.

The Bacchus/Shapiro memo acknowledges that the question of whether a measure is a prohibited (or actionable) subsidy under the SCM Agreement requires a highly fact-specific analysis. The memo then proceeds on the basis of the authors' understanding of the operation of the Chinese currency regime without considering the practical implications and effects of that regime on Chinese exporters. Bacchus/Shapiro memo, at 2-3. Instead, the memo finds two fundamental problems that they view are likely to weigh against a WTO panel finding that the Chinese exchange rate regime is a prohibited export subsidy within the meaning of Article 3.1(a) of the SCM Agreement. First, the memo foresees difficulty in arguing that the regime provides a "financial contribution" or "income or price support" and, thus, does not provide a subsidy within the meaning of Article 1.1(a) of the SCM Agreement. Second, the memo concludes that even assuming *arguendo* that the regime does provide a subsidy, the subsidy is not contingent *in fact* on export performance.

Because there are differing views on these fact-intensive issues, as evidenced by the Section 301 petition, and because any challenge of H.R. 1498 would be a case of first impression for the WTO, we provide the following supplemental analysis, which concludes that, while the WTO-consistency of any U.S. law is subject to possible challenge, there are strong arguments that H.R. 1498 is consistent with U.S. obligations under the SCM Agreement.

B. Financial Contribution

According to the Bacchus/Shapiro memo, the government's pegging of the value of the yuan to the value of the U.S. dollar does not "involve a transaction of the nature, or the kind of transfer of economic resources, that constitutes a 'financial contribution' under any of the subparagraphs of Article 1.1(a)(1)" of the SCM Agreement. Bacchus/Shapiro memo, at 7. Likewise, the Bacchus/Shapiro memo finds that exchange-rate manipulation would not be a form of income or price support in the sense of GATT Article XVI and within the meaning of Article 1.1(a)(2) of the SCM Agreement. Bacchus/Shapiro memo, at 8. According to the memo, Article 1.1(a)(2) is likely to refer to conventional income or price support programs for specific products intended to maintain income or prices at levels higher than they otherwise would be.[1]

It is not clear, however, why the exchange of currency at an undervalued rate would not be a "direct transfer of funds" or at the very least government revenue foregone within the meaning of SCM Agreement Articles 1.1(a)(1)(i) or (ii). According to the Appellate Body, "a 'subsidy' involves a transfer of economic resources from the grantor to the recipient for less than full consideration."[2] [3] *US – DRAMS CVD*, WT/DS296/AB/R, para. 125, n.212, *citing Canada – Dairy,* WT/DS103/AB/R, WT/DS113/AB/R, para. 87. While the Appellate Body in *US – Softwood Lumber IV* recognized that "not all government measures capable of conferring benefits would

[1] Unlike the Bacchus/Shapiro memo, the Section 301 Petition relies on the Second Report on AD/CVD Duties adopted in 1960 as well as a panel report in *Brazil – Aircraft* to argue that a financial contribution does not require a "payment" but can include "measures having an equivalent effect." Section 301 petition at 59-60, n.67. According to the Second Report on AD/CVD Duties, "the word 'subsidies' covered not only actual payments, but also measures having an equivalent effect." BISD 9S/194, 200, para. 34.

[2] *See also US – Softwood Lumber IV*, WT/DS257/AB/R, para. 19 ("The concept of subsidy defined in Article 1 of the *SCM Agreement* captures situations in which something of economic value is transferred by a government to the advantage of the recipient.").

[3] While the Bacchus/Shapiro memo, at 6, notes that the Appellate Body in the *US – DRAMS CVD* dispute was reluctant to find that a Member's exercise of general regulatory powers constituted a "financial contribution," the Chinese exchange rate regime is more than an exercise of general regulatory powers. Moreover, the *US – DRAMS CVD* case involved an alleged indirect financial contribution through a private body under SCM Agreement Article 1.1(a)(1)(iv) not a "direct transfer of funds" or government revenue foregone within the meaning of SCM Agreement Articles 1.1(a)(1)(i) or (ii). *US – DRAMS CVD*, WT/DS296/AB/R, para. 115.

necessarily fall within Article 1.1(a)," it also recognized that a "wide range of transactions" and "government measures" fall within the meaning of that provision. WT/DS257/AB/R, para. 20, n.35. In other words, a "financial contribution" is not limited to a governmental transfer of money directly to the recipient.

For example, in *US – Softwood Lumber IV*, the Appellate Body considered whether Canadian provinces provided a financial contribution by "provid[ing] goods" within the meaning of SCM Agreement Article 1.1(a)(1)(iii). The Appellate Body explained that it was the *consequence* of the transaction that must be considered in determining whether or not the government has provided goods. *Id.* at para. 43. In that case, stumpage arrangements gave tenure holders a right to enter onto government lands, cut standing timber, and enjoy exclusive rights over the timber that was harvested. The Appellate Body concluded that the consequence of the transaction was that the government provided harvesters with standing timber. *Id.* The Appellate Body further noted that the evidence suggested that "making available timber is the *raison d'etre* of the stumpage arrangements." *Id.* Therefore, the Appellate Body upheld the panel's finding that the U.S. determination that the Canadian provinces provided a financial contribution in the form of goods by providing standing timber to timber harvesters through stumpage programs was "not inconsistent" with Article 1.1(a)(1)(iii). *Id.* at para. 76.

The Appellate Body in the *EC – Sugar* case has also broadly construed Agriculture Agreement Article 9.1(c), which imposes reduction commitments on export subsidies provided through "payments on the export of an agricultural product that are financed by virtue of governmental action...." The Appellate Body in *EC – Sugar* upheld the panel's conclusion that the government's cross-subsidization of the production of C sugar constituted a "payment" in the form of transfers of financial resources on export financed by virtue of governmental action resulting from the operation of the EC sugar regime within the meaning of Article 9.1(c):

> 7.331 The Panel is thus of the view that EC sugar producers *finance* sales of C sugar at below cost of production directly by participating in the domestic market and making sales internally at high prices as regulated by the European Communities (and from the purchase of discounted C beet as discussed earlier). The European Communities' governmental action controls virtually all aspects of domestic sugar supply and pricing. The European Communities provides this control through a combination of guaranteed intervention prices, production quotas and import restraints which limit the quantity of quota sugar that may be sold in the internal market, and the resulting high domestic price for A and B quota sugar. The domestic sales offer lucrative and attractive returns to producers. Government action controls the supply of domestic sugar by way of quotas in pursuit of protecting high domestic prices well above the intervention price.

> Additionally, penalties levied against sugar producers that divert C sugar production into the domestic market are evidence of further governmental control. The collection of production levies and distribution of export refunds also contribute to the high degree of EC governmental control. Lastly, the imposition of high import tariffs illustrates again governmental action in the EC sugar regime.
>
> 7.332 Accordingly, the EC sugar regime uses the high profits on A and B quota sugar to cover fixed costs for C sugar and, most importantly, requires C sugar to be exported and diverted from the domestic market. Again, the result of the EC sugar system is not the production of C sugar in marginal or superfluous amounts simply in the pursuit of ensuring quota fulfilment. Rather, as the EC Court of Auditors stated, over the past years, C production has varied between 11 and 21 per cent of quota production, a significant portion of the European Communities' entire sugar production.
>
> 7.333 In the Panel's view, the EC sugar regime and the cross-over benefits that it creates are thus the direct and foreseeable consequences of actions by the European Communities, within the meaning of Article 9.1(c) of the *Agreement on Agriculture*, not merely the decisions of private sugar producers responding to market incentives.
>
> 7.334 Therefore, the Panel finds that the production of C sugar receives a payment, through cross-subsidization resulting from the operation of the EC sugar regime; there is a payment, in the form of transfers of financial resources on export *financed by virtue of governmental action.*
>
> 7.335 Pursuant to Article 10.3 of the *Agreement on Agriculture*, the Panel finds that the European Communities has not demonstrated that exports of C sugar that exceed the European Communities' commitment levels since 1995 and in particular since the marketing year 2000/2001, are not subsidized. Consequently, the European Communities is acting inconsistently with Articles 3 and 8 of the *Agreement on Agriculture*.

WT/DS265/R, WT/DS266/R, WT/DS283/R, paras. 7.331-35 (emphasis added); WT/DS265/AB/R, WT/DS266/AB/R, WT/DS283/AB/R, para. 278.

Likewise, in *Canada – Dairy,* the Appellate Body found that Canada's dairy regime constituted an export subsidy under Agriculture Agreement Article 9.1(c) because the provision of milk at reduced or below market prices constituted "payments" within the meaning of Agriculture Agreement Article 9.1(c). The Appellate Body specifically considered whether the transfer of economic resources constituting a "payment" within the meaning of Article 9.1(c) had to be in the form of money or could take other forms. WT/DS103/AB/R, WT/DS113/AB/R, para. 107. In the Appellate Body's view, the payments could be made in a form, other than money, that confers value, such as by way of goods or services, and includes revenue foregone. *Id.* at 107, 112. The Appellate Body explained that the "foregoing of revenue usually does not involve a monetary payment." *Id.* at para. 110 (citing Agriculture Agreement Article 1(c)). The Appellate Body found that the provision of milk at discounted prices to processors for export constituted non-monetary "payments" within the meaning of Article 9.1(c) in an amount equal to the portion of the price not charged. WT/DS103/AB/R, WT/DS113/AB/R, para. 113.

While Article 9.1(c) of the Agriculture Agreement is not identical to Article 1.1(a) of the SCM Agreement, the Appellate Body's recognition that a "payment" on the export of agricultural products can occur through the effects of a government regime should not be overlooked.

The plain language of Article 1 of the SCM Agreement and the WTO case law to date confirm that a government need not issue a check to an exporter to provide a "financial contribution." As explained in the Section 301 petition, China's currency regime provides a real financial contribution to Chinese exporters through the exchange of currency at an undervalued rate:

> The Chinese government requires its citizens to exchange their dollars for local currency, sets the rate of exchange by fiat, and prints the money to fund the transaction. By directing the conversion of U.S. dollars at an extremely undervalued rate of 8.28 Yuan for each U.S. dollar, the Chinese government provides a financial contribution....

Section 301 Petition, at 60. In other words, the Chinese exchange rate regime requires banks to exchange U.S. dollars <u>by overpaying them</u> Chinese Yuan. The additional Chinese Yuan received by exporters in the form of cash represents a direct transfer of funds, within the meaning of SCM Agreement Article 1.1(a)(i), or at the very least government revenue foregone, within the meaning of Article 1.1(a)(ii).[4] The Section 301 petition also suggested that:

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[4] The Section 301 petition points out correctly that "[t]o the extent that the Chinese government entrusts or directs any private bodies to assist in effectuating the yuan's undervaluation, which assistance appears also to take place, the conclusion still holds under Article 1.1(a)(1)(iv) that the Chinese government is providing a financial contribution and service as defined by the SCM Agreement." Section 301 petition at 60, note 68.

> China's currency manipulation further contributes financially to Chinese exports to the United States and elsewhere by shielding Chinese exporters from expenses involved with hedging against foreign-exchange losses or purchasing guarantees to guard against exchange-rate fluctuations. These costs are avoided thanks to the Chinese government's guarantee of a substantially undervalued, pegged-exchange rate that prevents any currency fluctuations between the Yuan and the U.S. dollar.

Id. at 61. Moreover, the currency exchange can also be viewed as a financial contribution because it provides Chinese exporters a "service" at non-market rates within the meaning of Article 1.1(a)(1)(iii). Hence, while the Bacchus/Shapiro memo conservatively concludes that the "financial support" requirement is not met, a review of the WTO case law set out above supports a contrary conclusion, and the particular facts at issue have never been considered in a WTO dispute settlement proceeding.

C. *De Facto* Contingent Upon Export Performance

The Bacchus/Shapiro memo concludes that, assuming *arguendo* that the Chinese currency regime is a subsidy, it is not a prohibited export subsidy because its grant is not "tied to" exports. Bacchus/Shapiro memo, at 9.

With respect to *de facto* export contingency, footnote 4 to Article 3.1(a) of the SCM Agreement states that the standard "is met when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision." Thus, the critical issue is whether or not the grant of the subsidy is "tied to" actual or anticipated exportation or export earnings.

There have been at least two adopted panel or Appellate Body decisions finding *de facto* export contingency within the meaning of Article 3.1(a): *Australia – Automotive Leather II* and *Canada – Aircraft.* According to the adopted panel report in *Australia – Automotive Leather II,* the sales performance targets set out in the grant contract constituted export performance targets because (1) the government was aware that the producer would have to continue and probably increase exports to reach the targets, and (2) the Australian market was already too small to absorb the producer's production, much less any expanded production that might result from financial benefits accruing from the grant payments and required capital investments which were to be specifically for automotive leather operations. *Australia – Automotive Leather II,* WT/DS126/R, paras. 9.67, 9.71. Therefore, the panel found that the producer's "anticipated export

performance was one of the conditions for the grant of the subsidies" and was compelling evidence of a close tie between anticipated exportation and the grant of the subsidies. *Id.*

The Appellate Body in *Canada – Aircraft* upheld the panel's finding that the TPC program was *de facto* export contingent. In doing so, the Appellate Body explained that the legal standard to establish *de jure* and *de facto* contingency was the same, but the evidence required to establish their contingency differed. Specifically, proof of a *de facto* export contingency is based on an inference from the "total configuration of the facts constituting and surrounding the granting of the subsidy, none of which on its own is likely to be decisive in any given case." *Canada – Aircraft,* WT/DS70/AB/R, para. 167. The Appellate Body then agreed with the panel that the relevance of particular facts will depend on the circumstances of the particular case and that "there can be no general rule as to what facts or what kinds of facts *must* be taken into account." *Canada – Aircraft,* WT/DS70/AB/R, para. 169.

Interpreting the language of footnote 4, the Appellate Body explained that the words "tied to" in footnote 4 required that a relationship of **conditionality or dependence** must be demonstrated. *Canada – Aircraft,* WT/DS70/AB/R, para. 171. The Appellate Body also interpreted footnote 4 as not permitting an affirmative finding based solely on (1) evidence that a government granting a subsidy *anticipated* that exports would result, or (2) evidence that a government knew that a recipient's sales were export-oriented. *Canada – Aircraft,* WT/DS70/AB/R, paras. 169-173. While evidence of these facts may be taken into account, they cannot support an affirmative finding alone.

Applying the legal test to the facts in that case, the Appellate Body affirmed the panel's finding that the TPC assistance to the Canadian regional aircraft industry was *de facto* export contingent based on consideration of the sixteen factual elements, including: TPC's statement of its overall objectives; types of information called for in applications for TPC funding; the considerations, or eligibility criteria, employed by TPC in deciding whether to grant assistance; factors to be identified by TPC officials in making recommendations about applications for funding; TPC's record of funding in the export field, generally, and in the aerospace and defence sector, in particular; the nearness-to-the-export-market of the projects funded; the importance of projected export sales by applicants to TPC's funding decisions; and the export orientation of the firms or the industry supported. *Canada – Aircraft,* WT/DS70/AB/R, para. 175.

The lack of the requisite "tie" in *Canada – Aircraft II,* however, led the panel in that case to reject allegations of *de facto* export contingency based on the size of the domestic market. Specifically, the panel acknowledged that the government "was very likely aware that the Canadian domestic market was too small to absorb Bombardier production" but concluded that the program was not operated in a way to suggest that the equity guarantees were *de facto* export contingent. *Canada – Aircraft II,* WT/DS222/R, paras. 7.360, 7.377-78. In doing so, the panel distinguished the TPC program discussed in *Canada – Aircraft* which (1) required TPC employees to focus on the volume of export sales resulting directly from the project, (2) involved TPC business plans which recorded

the proportion of the aerospace and defense industry's revenue allocable to exports, and (3) involved firms exporting 80 percent of their shipments. *Id.*

In the case of China's currency regime, the subsidy is *de facto* export contingent. As the Section 301 petition explained, "the subsidization would not occur if exports did not occur. In order for the foreign-exchange program to operate, products must be traded internationally. Without export performance, there would be no foreign currency to exchange." Section 301 petition at 65. Thus, there is a "relationship of conditionality or dependence." *Canada – Aircraft,* WT/DS70/AB/R, para. 171. The granting of the subsidy is not based merely on "knowing that a recipient's sales are export-oriented." *Canada – Aircraft,* WT/DS70/AB/R, para. 173. Without exportation there can be no subsidization. Hence, the subsidy provided by China's currency regime is "tied to" exports within the meaning of the SCM Agreement. This conclusion is supported by WTO case law.

D. A Subsidy's Availability To Non-Exporters Does Not Dissolve the Export-Contingent Nature of the Payments to Exporters

The Bacchus/Shapiro memo concludes that a WTO panel would not find the currency regime to be a prohibited export subsidy that is *de facto* contingent on export performance because it lacks the requisite "tie to" exports. Bacchus/Shapiro memo, at 9-10. Instead, the memo explains that any alleged subsidy is "tied to" having U.S. dollars, as a result of foreign profits, foreign investments or from exports. The memo also notes the lack of evidence indicating that exports are singled out for special treatment or subject to different conditions. Bacchus/Shapiro memo, at 10.

Yet, SCM Agreement Article 3.1(a) specifically states that a subsidy can be contingent upon export performance "whether solely or as one of several other conditions." Indeed, the Appellate Body has twice rejected arguments that receipt of subsidy payments by non-exporters somehow dissolves export contingency for exporters. For example, in *US – Upland Cotton*, the Appellate Body rejected the U.S. argument that its Step 2 payments were not export contingent because they were also available to domestic users. *US – Upland Cotton,* WT/DS267/AB/R, paras. 564, 576. The Appellate Body explained that the fact that a subsidy was also available to domestic users did not "dissolve" the export-contingent nature of the payments to exporters. *Id.* at para. 578. Rather, the Appellate Body found that program to be *de jure* export contingent because the statute and regulations (1) distinguished between two types of recipients (eligible exporters and eligible domestic users), and (2) established different conditions for each type to receive payments, *i.e.,* an exporter had to demonstrate that the upland cotton had been exported to receive a payment. *Id.* at paras. 576-77.

In doing so, the Appellate Body relied on its decision in *US – FSC (Article 21.5 – EC)*. In *US – FSC (Article 21.5 – EC),* the Appellate Body found that the fact that subsidies may not be export-contingent in all "situations" in which they provide benefits did not affect its conclusion that the subsidy was export-contingent in one of those

"situations." WT/DS108/AB/RW, at para. 119. In that case, the ETI measure at issue contemplated two different factual situations, one involving property produced within the United States and held for use outside the United States, and the other involving property produced outside the United States and held for use outside the United States. *Id.* The Appellate Body observed that the conditions for the grant of the subsidy with respect to property produced outside the United States were distinct from those governing the grant of the subsidy in respect of property produced within the United States. *Id.* at para. 114. Therefore, the Appellate Body examined the two situations separately and concluded that the first situation would require the exportation of property produced within the United States to receive the tax exemption. *Id.* at paras. 115, 119. The fact that the same measure grants subsidies that might not be export contingent to those in the second situation did "not dissolve the export contingency arising in the first set of circumstances." *Id.* at para. 119.

Thus, the simple fact that enterprises in possession of dollars from inflows of foreign direct investment or repatriation of profits earned abroad benefit from China's currency regime, along with exporters, does not make the action of the Chinese government any less of an export subsidy. In addition, the value of foreign direct investment in China and Chinese overseas investment (and consequently repatriation of profits) pales in comparison to the value of Chinese exports. In 2005, the value of Chinese exports was US$762 billion[5], while the value of foreign direct investment in China was only US$60.3 billion[6] and the value of Chinese overseas investment was just US$6.92 billion.[7] Moreover, as the recent WTO Trade Policy Review of China explained, "FDI has served as a platform, enabling China to manufacture products that meet world-market specifications with regard to quality, design, and technological content, thereby greatly contributing to the export orientation of the economy."[8] So, even foreign direct investment is generally oriented toward export production, which in turn leads to greater subsidization through China's currency regime.

In any event, it cannot be the case that a program that primarily benefits exports is deemed to not be an export subsidy simply because a relative handful of non-exporting enterprises also benefit. As explained, WTO case law supports this conclusion.

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[5] Trade Policy Review, Report by the Secretariat, People's Republic of China, Revised, WT/TPR/S/161/ Rev.1, at 257, Annex AI.1 (June 26, 2006) ("China TPR").

[6] China TPR, at 24, note 79.

[7] Website of the Ministry of Commerce of the People's Republic of China (MOFCOM), http://english.mofcom.gov.cn/aarticle/statistic/foreigninvestment/200607/20060702705397.html (Accessed Sep. 21, 2006).

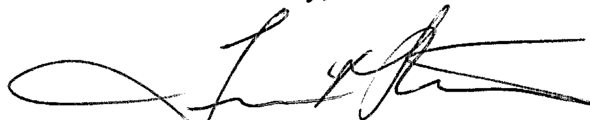
[8] China TPR, at 5.

E. Conclusion

The Bacchus/Shapiro memo addresses the question of whether H.R. 1498 is consistent with the WTO Agreement. With various qualifications which recognize that any actual WTO challenge of any U.S. law treating China's foreign exchange regime as a subsidy would be dependent on the facts of the case presented, the Bacchus/Shapiro memo nonetheless draws the conclusion that such a law would likely be found WTO inconsistent if challenged by China. We respectfully disagree. While we agree with much of the Bacchus/Shapiro memo's review of the basic elements identified as needing to be addressed, we disagree with the conclusion drawn. As this memo has reviewed, WTO case law supports the view of those who support H.R. 1498. China's foreign exchange rate program should be viewed as a financial contribution, the resulting subsidy is tied to exports such that it is an export subsidy, and hence it is prohibited under the SCM Agreement, or in the least it is actionable and may be addressed by U.S. countervailing duty law.

As is true with any law or regulation adopted by a WTO member government, no one can know with certainty that the law or regulation, if challenged at the WTO, will not be found to violate some aspect of a WTO Article or WTO Agreement. The same can be said with respect to review by domestic courts of a law's consistency with the U.S. Constitution or of a regulation's consistency with U.S. law. The Bacchus/Shapiro memo acknowledges this uncertainty as do we. Such uncertainty by itself is not a basis to oppose legislation where existing WTO provisions and decisions provide a basis for believing that the legislative approach would be WTO-consistent. The portion of H.R. 1498 that deals with recognizing that currency manipulation is a countervailable subsidy fairly can be viewed as WTO-consistent. The concerns raised in the Bacchus/Shapiro memo are, in fact, addressable under the facts of the situation as they pertain to China, and as decided by adopted WTO panel and Appellate Body reports.

Sincerely,



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