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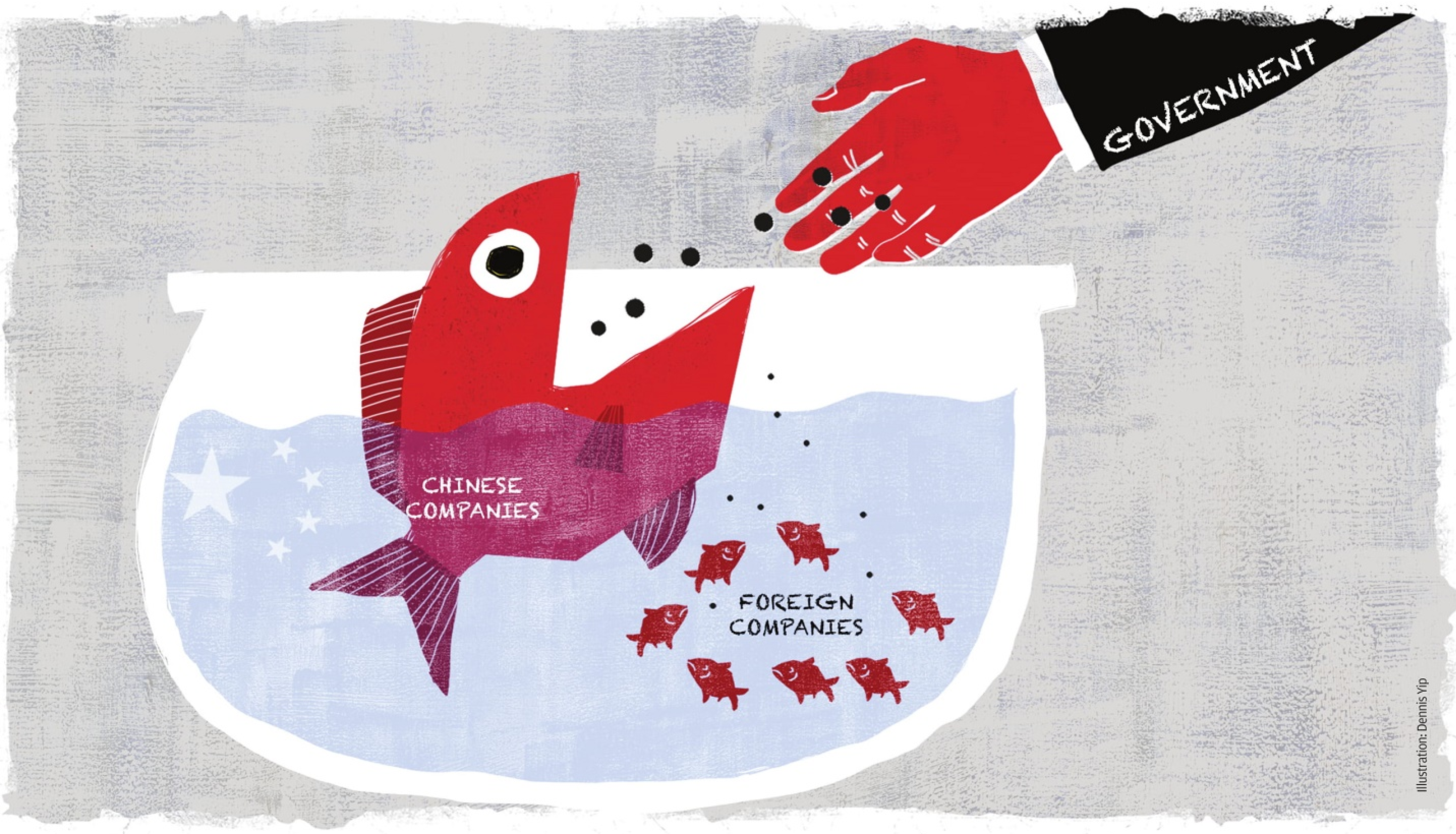

Illustration: Dennis Yip

Can mainland big fish be weaned off state help?

In the fourth of a five-part series looking at US demands for structural reform of China's economy, we examine the issues around Washington's call for a level playing field

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US President Donald Trump has delayed imposing extra tariffs on Chinese imports citing "substantial progress" in addressing the American demands for economic reforms. These demands are the conditions for ending the trade war.

The US demand: end to state subsidies and a level playing field

Curbing China's massive subsidies offered to domestic firms has long been a priority of United States Trade Representative (USTR) Robert Lighthizer in the trade talks with Beijing.

Even before the trade war, Lighthizer had made it clear in 2017 that the US objective should be eliminating unfair subsidies and "non-economic" industrial policy, all of which he described as an "unprecedented" threat to the world trading system.

In a joint report issued last month, the American Chamber of Commerce in China (AmCham China) and the US Chamber of Commerce also called on Washington to push Beijing to remove subsidies that artificially support domestic industries to ensure a level playing field for all companies operating on the mainland.

Since joining the World Trade Organisation (WTO) in 2001, Beijing has often been accused by the US and its allies of a lack of transparency in granting subsidies that favour domestic companies, giving them a competitive advantage.

Those subsidies came into sharp focus during the trade war, with Washington expressing particular concern with their use in Beijing's "Made in China 2025" industrial policy initiative that seeks to create global leaders in a range of cutting-edge hi-tech industries at the expense of the US and other developed countries.

> **China is too big to allow subsidies to go unaddressed**
>
> LESTER ROSS, OFFICIAL AT AMCHAM CHINA

In 2017 alone, hundreds of billions of yuan in subsidies were offered to mainland companies in a range of industries, with "Made in China 2025" only a small part.

Most of the money flowed to China's state-owned enterprises (SOEs), which also enjoy easy, low-cost access to loans. The subsidies and loans enhance their dominant position in multiple sectors including banking, insurance, energy, and transport.

This irked both foreign companies and domestic private firms, who complained that the advantages SOEs enjoyed allow them to crowd out competition and restrict market access.

The subsidies have also allowed mainland firms in certain industries to expand capacity and ship ever more goods to the rest of the world at lower prices.

Washington claims this has led to a "non-market driven" global oversupply in a range of products – including steel, aluminium and solar panels – harming US businesses and jobs.

WTO rules require member countries to disclose all subsidies that are provided to a specific enterprise or industry.

But the US claims Beijing has failed to disclose many of its subsidies, noting it took 15 years after joining the WTO to fill out its first report on local government subsidies.

"China never took it seriously that they really have to do this," said Craig Allen, president of the US-China Business Council (USCBC). "What are the subsidies, that is very unclear."

The US also complains that China had taken advantage of the WTO's vague definition of what constitutes a subsidy, allowing Beijing to adopt alternative channels – such as government-backed investment funds for the "Made in China 2025" initiative – to support favoured industries.

"China is too big to allow subsidies to go unaddressed," Lester Ross, chairman of the policy committee at the AmCham China, said.

US President Donald Trump meets the Chinese trade delegation led by Vice-Premier Liu He (left) in the Oval Office. Photo: AFP

Case study: 'Made in China 2025'

Beijing first introduced the "Made in China 2025" initiative in 2015, aiming to make itself the world's dominant player in 10 strategic hi-tech industries and so reduce reliance on foreign technology.

In 2017, Beijing offered more than 5.16 billion yuan (HK$6 billion) in subsidies to local governments to support the "Made in China 2025" programme, according to Ministry of Finance data.

Last year, "Made in China 2025" subsidies were 9.29 billion yuan.

In comparison, Germany allocated just 200 million euros (HK$1.78 billion) a year to fund its hi-tech strategy, Industry 4.0.

In addition to direct fiscal subsidies, Beijing set up a large number of state-owned venture capital funds to finance the project, including the National New Venture Capital Fund for Emerging Industries with over 40 billion yuan in capital, and the National Advanced Manufacturing Industry Investment Fund with 20 billion yuan at its disposal.

"They use government money but run in a private sector manner," Allen said.

"The US is concerned that massive sums of capital is being invested in hi-tech industries to allow Chinese national champions to dominate those industries in the future. This is state-driven … so it violates the WTO."

The foreign business community also argues that state-owned banks provide "inappropriate" subsidies, such as loans on non-commercial terms, to selected companies in "Made in China 2025" industries.

The subsidies and other help for "Made in China 2025" are also largely granted by provincial and municipal governments, further reducing transparency as data is fragmented.

What is China doing to address this?

After four days of trade negotiations in Beijing in February, Channel NewsAsia reported that China had pledged to end market-distorting subsidies and to bring all such programmes into compliance with WTO agreements.

¥9.29b

Beijing offered this much in subsidies last year, in yuan, to local governments to support the "Made in China 2025" programme

However, in the report, Beijing did not provide details on how this would be implemented.

The Wall Street Journal also reported that Chinese representatives had offered to eliminate subsidies given to mainland consumers for purchasing new-energy and fuel-efficient cars. Beijing began to gradually cut subsidies for new-energy cars in 2016 and halted funding for solar panel industries in May 2018.

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> CRAIG ALLEN, PRESIDENT OF THE US-CHINA BUSINESS COUNCIL

Beijing also stopped requiring local governments to work specifically on "Made in China 2025" projects, although local support for certain industries continues.

Vice-Minister of Finance Zou Jiayi argued the country's use of subsidies did not violate WTO rules, and noted Beijing had "fully abolished" subsidies that boosted export performance or promoted the use of domestic over imported goods.

She said China had submitted over 1,000 subsidy notifications to the WTO, including one covering all the provincial level subsidy policies between 2015 and 2016.

USCBC president Allen said that merely meeting the WTO requirements was not enough.

"What we really want is the removal of subsidies when they distort the market," he said.

Chances of meeting US demands

It would be very difficult for China to end all subsidies that affect trade, especially given politically powerful SOEs receive most of the benefit.

President Xi Jinping has made clear that SOEs are a primary pillar of the "market economy with Chinese characteristics", pledging that the country would "make no change where there should not and cannot be any reform".

This has led most foreign observers to expect little if any change in Beijing's subsidy practices as a result of the current trade talks.

"Anything's possible, but in my opinion the chance of China meeting US demands is virtually zero," said Usha Haley, a professor in international business and management at Wichita State University and an expert on Chinese subsidies.

"I am not optimistic as China has made no structural changes [in recent years]; indeed, subsidies have actually risen."

Mainland companies in strategically important industries, including those identified in the "Made in China 2025" initiative, had virtually unlimited direct lines to "free money" and other non-monetary support, she said.

Ross, the chairman of AmCham China's policy committee, said a strong nationalistic determination to boost economic growth would also limit the chances of Beijing meeting Washington's demands.

"You can't have your cake and eat it too," he said. "China has been able to enjoy the subsidies for so long, they are unlikely to give them up."

In addition, the central government did not fully control local authorities, who were motivated to offer subsidies to local businesses for political or personal gain, he added.

USCBC president Allen said the first step would be to agree on clearer definitions of subsidies under the WTO so that all members understand the limits.

"The words I use need to have the same meanings to you. If not, there will be problems," he said.

Part five in the series will look at enforcement of the US demands