THE IMPACT OF CHINA'S INDUSTRIAL SUBSIDIES ON COMPANIES AND THE RESPONSE OF JAPAN, THE UNITED STATES, AND THE EUROPEAN UNION

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SUMMARY

- In recent years, with the globalization of business, companies have begun to be influenced by subsidies granted by foreign governments to companies in their own country. Particularly significant is the impact of the subsidies that China gives to its domestic companies and the response of Japan, the United States, and the European Union, which view those subsidies as problematic.

- Subsidies provided to the Chinese steel industry have ended in overproduction, which in turn has negatively affected companies in other countries, including the deteriorating conditions of the international market. Japan, the United States, and the European Union are leading the way in promoting the establishment of international rules to curb such situations, but exactly when that will happen is still up in the air. There is concern that the same situation will repeat itself in China's other industries.

- On the flip side, if the subsidies for semiconductors and other products that have promoted China's high-tech industries and drawn protests from the United States are restricted, it could make it difficult to continue the tie-ups between Japanese and Chinese companies that have been developed in this sector.

1. INTRODUCTION

So-called industrial subsidies (hereinafter "subsidies"), which are granted in many countries to achieve their industrial policies, have produced tremendous results over the years. At the same time, however, problems have long been pointed out.[1] In some cases, subsidies have been used to protect domestic industries more than necessary, hindering free competition. Since the start of the 21st century, China and other emerging countries have experienced remarkable economic growth. Meanwhile, by massively subsidizing their own industries, they have brought about negative impacts on the industries and companies of other countries, and this in particular is seen as a problem.

Addressing this problem will require the establishment and strict enforcement of international rules on national subsidy policies. However, the WTO Agreement on Subsidies[2], which is currently the only global rule governing subsidies, does not sufficiently address the implementation of the subsidy policies of China and other emerging countries. For that reason, Japan, the European Union, and others have followed the lead of the United States in calling for strict enforcement and have been working on creating international rules.

At this point in time, however, it remains unclear when rules that would be acceptable to all countries might be completed, so for the time being, companies will continue to be influenced by the degree of enforcement and progress on establishment of such rules. Meanwhile, the response of Japan, the United States, and the European Union to China's subsidy policies is likely to have a significant impact on companies. This paper sorts

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[1] For example, the Report on Compliance by Major Trading Partners with Trade Agreements published by the Ministry of Economy, Trade and Industry of Japan in 2017.
[2] The official title is "Agreement on Subsidies and Countervailing Measures."

the problems related to these subsidies into three categories, namely the response to China's enforcement of the WTO Agreement on Subsidies, moves to revise the WTO Agreement on Subsidies and, as a further issue, subsidies for the high-tech and service industries, and looks at the influence of each on companies.

2. CHINA'S ENFORCEMENT OF THE WTO AGREEMENT ON SUBSIDIES AND THE IMPACT ON COMPANIES

2-1. Main points of the WTO Agreement on Subsidies

In the WTO Agreement on Subsidies[3], a subsidy is defined as a financial contribution by a government or any public body which provides a benefit with the recipient company. Generally, the word "subsidy" invokes money given to a company by a government. However, the word as used here refers to a broader concept, namely monetary value of any form that is transferred from a government or public body to a company without receiving reasonable compensation from the company. For example, investments, tax reductions, waived loan guarantee revenue, loans provided at lower interest rates than those offered by private financial institutions, and purchases of products from a company at a higher price than market value are considered subsidies.

In the said agreement, "government" refers not only to central governments but also to local governments, including provincial and city governments in China. Additionally, there is no clear definition of "public body," but it refers to bodies that possess, exercise or have been delegated governmental authority. For example, Chinese state-owned commercial banks are considered public bodies, but state-owned enterprises are not.

Out of the subsidies prohibited under the agreement, export subsidies warrant attention. These are subsidies granted based on the act of exporting and include any applicable case regardless of pretext.

2-2. Overproduction in China resulting from subsidies

Subsidies said to be the main factor behind the production in China in recent years are cited as a classic example of subsidies that have negatively affected the companies of other countries, including Japan. Industries that have experienced excess production in China include coal, aluminum, and shipbuilding, but the leading example is the key industry of steel.[4] As such, the Chinese steel industry will be used as the example in this paper.

Since entering the 2000s, crude steel production in China has expanded rapidly. In 2013, it exceeded 800 million tons, reaching half the total global production volume. China became a net steel exporter in 2006, and internal demand peaked in 2013. In conjunction with this, the steel industry fell into a recession, and many of the 33 listed companies in the steel industry posted operating losses in 2015. Looking at the amount of subsidies provided to these 33 companies during this time, it was only 1.5 million dollars in 2001 but climbed to 100 million dollars in 2008 and reached a record-high of more than 1 billion dollars in 2015. Since then, the amount has decreased, but the subsidies continue. Based on this situation, the Ministry of Economy, Trade and Industry of Japan has concluded that this "indicates that the governmental subsidies were in effect a measure to make up for companies' losses and extend the life of companies with low profitability."[5]

As a result of measures to extend the life of companies, the surplus steel was transferred overseas, resulting in a sharp rise in Chinese steel exports. Net exports (the value of total exports minus the value of total imports) of

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3 The WTO Agreement on Subsidies covers a broad range of issues, but due to space constraints, the explanation here is limited in scope to what is necessary for understanding this paper. Refer to the document from Note 1 for a systematic explanation.

4 According to the RIETI Discussion Paper Series 17-J-058 "Overcapacity Problem and Subsidies in China's Steel Industry: A test on the existence of soft budget constraint" by Mariko Watanabe of Gakushuin University, "distortions within China's own system" are to blame for overcapacity. Her analysis is that "The mechanism of supporting the steel industry through government subsidies in order to protect local economies and employment remains in place, and the exit is difficult and has resulted in taking losses on production and exports."

5 White Paper on International Economy and Trade 2018, Ministry of Economy, Trade and Industry.

crude steel in 2006 when exports first exceeded imports were a mere 28 million tons, but the amount has continued to increase, and by the peak in 2015, they had exceeded 100 million tons. At that point, the Chinese share of global steel exports reached around 25%.

As steel exports from China have increased, the price has dropped and lead to deterioration of the international market. In 2008, the unit price of steel exported from China was 1.04 dollars per kilogram, while the global average was 93 cents per kilogram. After that, as the unit price of Chinese steel dropped, the global average also dropped, and by 2016 the unit prices had fallen to 45 and 50 cents per kilogram, respectively.

In response, China voluntarily began to work on resolving the problem of its excessive steel production capacity in 2016. Over the three-year period until 2018, China shrank its capacity by 150 million tons through merger-based industry reorganization and other means and has indicated that it considers the problem of excessive steel production to have thereby been resolved.[6]

2-3. Suspicion of Chinese violations of the WTO Agreement on Subsidies

Japan, the United States, the European Union, and various other countries strongly suspect that China has violated the WTO Agreement on Subsidies in their overproduction and export of steel.[7] The reason for so many suspicions without clear allegations of violations is that it is difficult to ascertain the overall picture and details of Chinese subsidies, such as the amounts, origin, recipient, and use. WTO member states have an obligation to report any subsidies granted to the WTO, but China has not provided sufficient reports to date.[8] The burden of proof related to violations of the agreement falls on the party making the allegation, so without being able to ascertain the actual situation of subsidies in China, other countries remain unable to satisfactorily prove violations.[9] Under these circumstances, other countries believe that the subsidies granted to the Chinese steel industry include a large amount of export subsidies.[10]

However, this alone is not thought to be the extent of China's violation of the WTO Agreement on Subsidies in its steel subsidies. The subsidy amount mentioned above only applies to the 33 listed companies. However, in China, the number of state-run steel manufacturers alone exceeds 100, and when private companies are included, the number rises to around 700. Many of these are believed to receive subsidies, and transparency is especially lacking in cases of subsidies provided by local governments.[11]

By black boxing its subsidies, China continues to avoid charges of violations of the WTO Agreement on Subsidies while pursuing its own industrial policies. Japan, the United States, the European Union, and other countries consider China to be harming the industries and companies of other countries as a result. This includes causing the deterioration of the international steel market and strengthening Chinese control over the global market by way of the creation of gigantic companies and oligopolization through mergers.

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[6] "International Steel Forum to End, China Opposes Continuation," NNA, October 28, 2019.

[7] This point is mentioned in the document from Note 5 as well as the USTR's annually issued "Report to Congress on China's WTO Compliance."

[8] At the ministerial meeting of the "Global Steel Forum" held in September 2018 to discuss the problem of steel excess production and attended by Japan, the United States, the European Union, and other countries, a resolution was adopted calling for China to submit unsubmitted information on its subsidies, but that information has yet to be fully provided. Additionally, the Joint Statement of the Trilateral Meeting of the Trade Ministers of Japan, the United States and the European Union dated January 14, 2020 says that the current state of reporting on subsidies is miserable.

[9] According to RIETI Discussion Paper Series 11-J-067 "Characteristics of Subsidies Granted by China and Practical Challenges" by Fujio Kawashima of Nagoya University, the United States Business and Industry Council (USBIC), a manufacturing industry group, has publicly commented that "It is impossible for U.S. representatives or the industrial world to verify China's compliance to the agreement because of the secrecy and delay of its information submission ."

[10] The USTR has stated that "China has not notified all of its subsidies to the WTO." "2019 Report to Congress on China's WTO Compliance" March 2020, USTR.

[11] The U.S. Chamber of Commerce has stated that "Many of China's subsidies are actually granted at the local government level." "U.S.-China compromise becomes more difficult as China refuses to review local subsidies," May 9, 2019, *Asahi Shimbun*.

2-4. Continued concern over overproduction arising from subsidies

One of the impacts of this situation on the companies of other countries is said to be deterioration of the international market by a resumption of overproduction as a result of these subsidies.[12] As mentioned above, the reduction of steel production capacity is ultimately a voluntary action on the part of China. As things stand, the WTO Agreement on Subsidies is not functioning properly, and the negative impact of China's subsidization policies on the industries and companies of other countries cannot be prevented. Because of this, it would be simple for China to change course and substantially ramp up steel production again depending on their policies, including an increase in subsidies. In fact, since the reduction of steel production capacity was completed in 2018, China's crude steel production has been on the rise, reaching a record-high of 980 million tons in 2019. In light of this, there is concern over a return of the problem of excess production.[13]

Moreover, overproduction may result in other industries as well due to heavy subsidization, not just those that have previously experienced excess production like the steel industry, and this could cause those international markets to deteriorate. For example, this includes industries designated as key sectors in Made in China 2025, such as semiconductors, machine tools, new energy vehicles, and nanomaterials. In particular, the Chinese focus on self-manufacture of semiconductors has drawn attention. Currently, self-manufacture accounts for less than 40% of semiconductors, so they are not producing surplus. However, by 2022, China's semiconductor production capacity is expected to surpass that of South Korea and Japan, putting it in second place after Taiwan.[14] The Ministry of Economy, Trade and Industry and the USTR have pointed out the potential of a new problem of excess capacity arising in the Chinese semiconductor industry.[15] The problem of excess production in China is not as talked about as it was a few years ago. However, under the current situation of relying on voluntary restraint of China without fully functioning restrictions through international frameworks, the problem could rear its head again. On top of this, there are more industries in which production could occur than before.

3. MOVES TO REVISE THE WTO AGREEMENT ON SUBSIDIES AND THE IMPACT ON COMPANIES

3-1. Overview of moves to revise the WTO Agreement on Subsidies

As mentioned above, Japan, the United States, and the European Union have been working on a proposal since 2017 in light of China's insufficient fulfillment of its obligations under the WTO Agreement on Subsidies and the current state of the agreement, which prevents a satisfactory response. After five meetings, they finally reached an agreement on proposed changes to the agreement at the trilateral trade meeting in January 2020.[16] The main changes are as shown in Figure 1.

3-2. Effects and limits of proposed changes to the WTO Agreement on Subsidies

It is clear that the proposal for revising the WTO Agreement on Subsidies was primarily devised to address Chinese subsidies that bring about overproduction. As such, if the agreement were to be revised based on this proposal, it is likely that it would ensure China's fulfillment of its obligations to a considerable degree. As a result, loss-generating companies would be weeded out, thereby contributing to the prevention of deterioration of international markets due to excess production, oligopolization and domination of global markets arising from corporate mergers, and decline of the profitability of companies in other countries.

[12] The Chair's Statement on the Ministerial Meeting of the Global Forum on Steel Excess Capacity dated October 26, 2019 notes that excess capacity persists.
[13] "Full-scale examination of enhancement of the steel industry and concerns over excess capacity," February 3, 2020, NNA.
[14] "China to become number two in the world in terms of semiconductor production capacity by 2022," June 30, 2020, *EE Times Japan*.
[15] Document from Note 4 and National Trade Estimate Report on Foreign Trade Barriers, 2020, USTR.
[16] "Trade Trilateral Targets China's Industrial Subsidies," Jan. 22, 2020, CSIS.

Figure 1. Main Content of Proposed Changes to WTO Agreement on Subsidies by Japan, the United States, and the European Union

1. Expansion of unconditionally prohibited subsidies
In addition to the current prohibitions on export subsidies and preferential subsidies for domestic products, the four items below are to be unconditionally prohibited: (1) Unlimited guarantees (2) Subsidies to "insolvent or ailing" enterprises that lack a "credible restructuring plan," also known as "zombie" companies (3) Subsidies to enterprises that "cannot obtain long-term financing from independent commercial sources operating in sectors or industries in overcapacity" (4) Certain direct debt forgiveness
2. Reversal of burden of proof
In the cases below, the defendant (subsidizer) and not the complainant would bear the burden of proof to show that there is no negative impact on the industries or companies of another country and that the granting of the subsidy has been transparent: (1) "Excessively large subsidies" (2) Subsidies to uncompetitive firms that help them stay in the market (3) Subsidies that create overcapacity without commercial participation (4) Subsidies that lower domestic input prices for exports
3. Ensuring reporting of subsidies
If the required information is not provided by a subsidizer, and that subsidy is counter-notified by another country, it would be considered a prohibited subsidy.
4. Applying restrictions to financial contributions made by state-run companies
Under the WTO Agreement on Subsidies, state-run companies are not considered public bodies, so financial contributions made by state-run companies are not considered subsidies. However, Japan, the United States, and the European Union say that many of China's subsidies are provided through state-run companies. They would like to redefine "subsidy" to include such financial contributions by state-run companies.

Source: Prepared by Mitsui & Co. Global Strategic Studies Institute based on the Joint Statement of the Trilateral Meeting of the Trade Ministers of Japan, the United States and the European Union dated January 14, 2020

It would also decrease the likelihood of future excess production in growth industries such as the semiconductor industry that have not previously been subjected to production. Furthermore, a revised WTO Agreement on Subsidies would not apply solely to China, so it would also decrease the likelihood of overproduction arising from subsidies in other countries.

However, at this point in time, when the revised agreement would take effect is still up in the air. Japan, the United States, and the European Union had hoped to discuss it at the Ministerial Conference, which is the topmost decision-making body of the WTO, in June 2020, but the conference was postponed until 2021 due to COVID-19. This has caused a delay in the efforts.

It cannot be said that the proposal has been put together in detail. They have agreed to conduct a detailed review of the subsidies that will be unconditionally prohibited, including whether others should be added to the four in Figure 1. This is expected to produce a detailed proposal and a more effective revision. However, it will take longer to complete. As such, until that happens, concern over the negative impact of overproduction brought about by subsidies on the companies of other countries will persist.

Subsidies prohibited by the WTO Agreement on Subsidies must be eliminated. However, there remains concern that even if an agreement incorporating the proposal were to go into effect and newly prohibited subsidies were to be eliminated, substantively the same subsidies would just be granted under a different name.[17] Eliminating prohibited subsidies would require not just discontinuing the granting of such subsidies but also measures, for

[17] According to the document from Note 9, the USBIC has made the criticism that "China is skilled at using various means to introduce alternative measures for subsidies."

example, to compensate the industries and companies of other countries for the damages they have caused. However, such measures have not been included in the proposal. As such, companies that have incurred damages will have no choice but to accept the situation.

4. SUBSIDIES FOR THE HIGH-TECH AND SERVICE INDUSTRIES AS A FURTHER ISSUE

4-1. Moves to restrict subsidies for the high-tech industry

The United States is not content with simply prohibiting Chinese subsidies that lead to production but also hopes to prohibit subsidies that further promote the innovative high-tech industry. The U.S. Chamber of Commerce says that the objective of Made in China 2025 is for China "to become a global leader in manufacturing high-quality and high-technology products."[18] The main sources of funding for this initiative are about 800 funds directed by the Chinese government, which are said to total around 2.2 trillion Chinese yuan. One of the leading examples is the National Integrated Circuit Industry Investment Fund for promoting the semiconductor industry. This fund is ostensibly a private fund, but in reality, it is a government fund led by a former high official to which major state-run companies like China Tobacco and China Mobile have contributed 138.7 billion yuan. Citing these government connections, the U.S. Chamber of Commerce has pointed out problems with the fund's independence.

Under the WTO Agreement on Subsidies, financial support from funds such as above is not categorized as a subsidy. The United States International Trade Commission, which is an independent agency of the United States government that aims to correct unfair trade policies and measures, noted that "Essential to China's semiconductor industrial plan are subsidies, which take the form of funds such as the National IC fund."[19] The commission views the contribution of these funds as subsidies. The USTR has expressed dissatisfaction with these subsidies, saying that because only companies that manufacture their products in China are eligible, American companies are forced to manufacture in China, which leads to fewer opportunities to export products from the United States and to drain of both employment and technology.[20]

According to the American newspaper The Wall Street Journal, under Made in China 2025, IT giant Huawei Technologies has received as much as 75 billion dollars in subsidies from the Chinese government. The newspaper also notes that Huawei is able to offer its products at prices around 30% lower than those of its rivals through this government support.[21] In other words, it is widely recognized in the United States that massive subsidies by the Chinese government are behind Huawei's global rise and that this has put American companies at a disadvantage.

Several US administrations have expressed frustration with Chinese subsidization policies such as this, and it is believed that the United States will push internationally for restrictions on subsidies for the high-tech industry as a permanent global rule.[22] It is unclear at this time whether the United States will gain the understanding of other countries, but if such restrictions are introduced in the future, the number of cases of the companies of other countries being negatively affected will likely increase in contrast to restrictions on subsidies that lead to overproduction. That is because Chinese high-tech companies have already built close relationships with companies from many other countries, including Japan. For example, Huawei's products have penetrated not just the communications industry but the entire industrial world through the NB-IoT communication standard for 5G and LTE-based IoT, including control equipment, and many Japanese companies have partnered with the company (Figure 2). If subsidies for the high-tech industry were restricted, it would become difficult for the companies of other countries to partner with Chinese companies in this industry as they have up to now.

[18] "Made in China 2025: Global Ambitions Build on Local Protections," 2017, U.S. Chamber of Commerce.
[19] "Chinese Semiconductor Industrial Policy: Past and Present," 2019, United States International Trade Commission.
[20] "Findings of the Investigation into China's Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation under Section 301 of The Trade Act of 1974," March 22, 2018, USTR.
[21] *The Wall Street Journal* digital edition, December 25, 2019.
[22] In trade talks between the United States and China, the United States demanded an end to "unfair" subsidies, including those for the high-tech industry. However, negotiations broke down, and the Phase One deal in January 2020 did not include an agreement on subsidies.

Figure 2. Japanese Companies Partnering with Huawei

A total of 50 companies from major countries including Japan, China, the United States, the European Union, and South Korea established the 5G standards. Among these were Huawei and Japanese companies like Panasonic, Fujitsu, Kyocera, NEC, NTT Docomo, and KDDI. In a joint statement, the 50 companies declared that they would accelerate collaboration with various industries and create new businesses for the commercial development of 5G.
Softbank signed an agreement with Huawei and Ericsson on field tests for commercial 5G services. This will involve field tests to provide a comfortable telecommunication environment in urban areas employing beam forming and space division multiplexing technologies.
Toshiba, Murata Manufacturing, and other Japanese companies have joined more than 2,000 companies from all over the world to participate in the Huawei OpenLab program. OpenLab is a place for promoting R&D on 5G and NB-IoT, including field tests.
Leading Japanese water and gas meter manufacturer Aichi Tokei Denki used Huawei's NB-IoT service development tool to build an automatic water meter reading system. The company said that Huawei's technology stands out from its global competitors.
Murata Manufacturing developed an NB-IoT communication module using a chipset made by HiSilicon, a semiconductor manufacturer under the Huawei umbrella.

Source: Prepared by Mitsui & Co. Global Strategic Studies Institute based on "Verification! The Capabilities of Huawei - [Part 1: Entering the Industrial Field] - Penetrating Automobiles and Control Equipment and Major Influence on 5G and IoT" from the April 2019 issue of Nikkei Electronics and press releases from each company

4-2. Subsidies for the service industry not covered by the WTO Agreement on Subsidies

The WTO Agreement on Subsidies is an agreement that concerns physical goods. In other words, it applies to subsidies for the manufacturing industry and not those for the service industry.[23] Moreover, the abovementioned proposal for revising the WTO Agreement on Subsidies also applies to physical goods. Even if companies from another country were to incur damages as a result of subsidies provided by a certain country to companies in the service industry leading to a deterioration of the international market for a particular service, it would not be possible to restrict those subsidies under the existing WTO Agreement on Subsidies. This would be the case even if the agreement were revised as proposed. Needless to say, the globalization of business is happening not only in the manufacturing industry but in the service industry as well. In particular, subsidies for the telecommunications services industry have the potential to significantly affect competitors from other countries due to the rapid innovation of digital technology. For example, a telecommunications services company receiving subsidies from a certain country could develop low-priced 5G services for IoT in a third country, potentially leading to an oligopoly in the market. Because of the difficulty for companies to find out whether or how another country is subsidizing the service industry, they could be negatively affected without knowing it.

5. CONCLUSION

It is difficult even at the national level to fully ascertain the substance of subsidization policies of another country, so it is possible for a company to receive an impact even more heavily than they realize. For companies, it would be desirable for economically rational global rules to be established with respect to national subsidization policies based on information disclosure. However, for the time being, such rules remain out of reach, and companies are subject to the various impacts mentioned above without the means to ascertain the substance of subsidization policies in other countries. Going forward, companies will have to focus even more on trends in subsidies.

[23] Document from Note 1.