China's Market Economy Status:

A Political Issue

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Abstract

The European Union is currently under pressure to decide as whether to grant Market Economy Status (MES) to China, when certain provisions in its World Trade Organisation Accession Protocol lapse on 11 December 2016. Although China's quest for market economy status is presented as a technical issue, a lack of clarity in the legal text has left the issue open to both interpretation and politicisation. As the deadline for a decision approaches, this paper analyses the political dimension of the options facing the EU, and their implications for Europe and EU-China relations.

Introduction

As part of its integration into the global economy, China became a member of the World Trade Organisation (WTO) on 11 December 2001. Certain provisions of China's WTO Accession Protocol which deal with the issue of dumping will expire on 11 December 2016. Under EU legislation, dumping occurs when a company exports its products to the EU at a price lower than the 'normal value' (domestic prices of the product or the cost of production) in its own domestic market.

In anti-dumping investigations, WTO members can impose additional duties on products from a country if an investigation demonstrates that the products were dumped. In normal circumstances, dumping is calculated by comparing the export price of a product at a lower price than the prices or cost in the exporting market.

However, WTO rules provide for the special treatment of countries that have a complete or substantially complete state monopoly of trade and prices fixed by the state. In recognition of its status as an economy in transition, under paragraph (a) (ii) of Article 15 of China's WTO Accession Protocol, WTO members are able to treat China as a Non-Market Economy (NME) in anti-dumping proceedings. As domestic prices are not considered a reliable basis for comparison with export prices, the EU employs the prices and costs from an analogue country to calculate the 'normal value'.

However, this provision is set expire on 11 December 2016, and a heated debate has erupted over the interpretation of Section 15 and whether WTO members can continue to treat China as a non-market economy in anti-dumping investigations.

Although Market Economy Status (MES) first presents as a technical issue, the ambiguous legal language used in subparagraph (a) (ii) has transformed Market Economy Status into a political issue as there are different interpretations and contradicting views on what will happen when the clause expires.

Beijing argues that Market Economy Status should be applied automatically in December 2016, and although many countries, including Australia, have proactively granted China Market Economy Status, the US and the EU remain undecided. Politicians and trade unions in the EU have warned that treating China as a market economy in anti-dumping investigations would be a serious blow to trade defences with severe implications for the economy, employment and the environment.

As the December deadline approaches, the EU seems to have three options:

1. *Unilaterally grant China market economy status;*
2. *Continue to treat China as a non-market economy in anti-dumping investigations; or*
3. *Grant China market economy status with additional trade defence measures.*

The following sections will examine the options facing the European Union.

Option One: Unilaterally grant China market economy status

The Value of Market Economy Status for China

Since becoming a member of the WTO, securing Market Economy Status has become a key objective for China in its relations with the EU.

China is one of the primary targets of EU anti-dumping measures. Chinese exports to the EU were the target of 119 investigations and 85 measures between 1995 and 2014[1] , with iron, steel and chemicals making up the sectors with the highest number of measures in force. Market Economy Status would result in lower anti-dumping duties for China, as the normal value would be constructed using domestic prices and costs rather than higher-priced third countries.

Arguably, Market Economy Status holds more political value than economic value for China. Only 1.38% of Chinese exports to the EU are affected by EU trade defence measures[2]. For China, Market Economy Status is a matter of prestige. It signals the reclamation of its position as a pivotal global player at the international level and its parity with major powers such as the US.

China points out that many countries, including Brazil, Russia and Argentina, have already granted China Market Economy Status. In many cases, early recognition of Market Economy Status has been granted for political reasons, such as concluding Free Trade Agreements and promoting Chinese foreign direct investment.

A Divided Europe

At a college orientation debate on 20 July 2016, the European Commission indicated its intent to treat China as a market economy in future trade disputes. The Commission is expected to introduce a proposal on the issue later this year, which will need to be approved by both the Council and the European Parliament.

1 "Granting Market Economy Status to China: An Analysis of WTO Law and of Selected WTO Members' Policy" (2015) European Parliament Research Service http://www.europarl.europa.eu/RegData/etudes/IDAN/2015/571325/EPRS_IDA(2015)571325_EN.pdf

2 "College Orientation Debate on Treatment of China in Anti-Dumping Investigations" (2016) European Commission Fact Sheet http://europa.eu/rapid/press-release_MEMO-16-61_en.htm

Securing the support of the European Parliament and Member States may prove difficult. For a start, the European Parliament voted against granting China market economy status in a non-binding resolution passed by 546 votes to 28, in May 2016 [3].

The Council is divided on the Market Economy Status on the basis of Member States' individual bilateral relations with China. Netherlands, Belgium and the Nordic countries have generally been supportive of granting China Market Economy Status, where as Spain, France and Italy have been the most vocal in its opposition. Without a decisive European voice on the matter, China could take advantage of the cleavages between Member States to leverage support for Market Economy Status. In general, the split between Member States on Market Economy Status is symptomatic of the greater issue of a lack of a clear united European voice in EU-China relations.

Implications for the EU

Many in the EU fear that granting China market economy status could open the EU to significant economic risks. As the standard method of measuring the anti-dumping margin may not account for ongoing distortions in the Chinese economy, they argue that Market Economy Status would allow Chinese goods to flood the European market and undercut domestic production, as it would be more difficult for the EU to impose anti-dumping measures.

A European Commission study, entitled Change in the Methodology for Anti-Dumping Investigations Concerning China[4], estimated the number of jobs in the sectors protected by anti-dumping duties against China as between 73,300 and 188,300. It also estimates that nearly half of these jobs are located in Germany and Italy. A study published by the Economic Policy Institute[5] argues that granting China Market Economy Status would overall: place between 1.7 million and 3.5 million EU jobs at risk; reduce EU output by between €114.1 billion and €228 billion per year; and reduce EU GDP by 1 to 2 percent.

What is also apparent is that the cost of Market Economy Status would be unevenly distributed where some industries and economies would be more adversely affected than others. Nowhere is this more evident than in Europe's steel industry where Market Economy Status has become entangled with China's overcapacity problem.

China's Overcapacity Problem

Overcapacity in China's steel industry is estimated at around 350 million tonnes, almost double the EU's annual production and more than double the EU's steel demand[6]. The steel industry in the EU is still facing recession, where steel demand in the EU is still 28% below the 2007 level. European steel manufacturers argue that the increase of cheap Chinese steel entering the European and global markets has caused a depression in global prices and placed pressure on European manufacturers.

Although the Chinese government has planned for significant restructuring of the steel industry and made commitments to cut steel production over the coming years, European steel manufacturers argue that it will not be enough to prevent it impacting on the European market.

3 "China's Proposed Market Economy Status: Defend EU Industry and Jobs, Urge MEPS" European Parliament Newsroom http://www.europarl.europa.eu/news/en/news-room/20160504IPR25859/China's-proposed-market-economy-status-defend-EU-industry-and-jobs-urge-MEPS

4 "Change in the Methodology for Anti-Dumping Investigations Concerning China" (2016) DG Trade, European Commission http://trade.ec.europa.eu/doclib/docs/2016/february/tradoc_154241.pdf

5 Unilateral Grant of Market Economy Status to China Would Put Millions of EU Jobs at Risk" (2015) Economic Policy Institute http://static1.squarespace.com/static/5537b2fbe4b0e49a1e30c01c/t/55fc0373e4b09a69209aa9c2/1443621109236/Unilateral+grant+of+Market+Economy+Status+to+China+would+put+millions+of+EU+jobs+at+risk.pdf

6 "Steel: Preserving Sustainable Jobs and Growth in Europe" (2016) European Commission Press Release http://europa.eu/rapid/press-release_MEMO-16-805_en.htm

Option Two: Continue to Treat China as a Non-Market Economy in Anti-Dumping Investigations

China's Economy

When China first joined the WTO, it relaxed some 7,000 trade barriers[7] and made commitments to further reform and to open its economy. Although China has made much progress in this regard, it fails to fulfill the five criteria laid out by the EU for evaluating market economy status.

State intervention in the economy remains high in a number of key sectors, affecting foreign direct investment and commodity prices. Granting China Market Economy Status while it does not fulfill these criteria may remove an important incentive for further reform of China's economy.

The EU's Five Criteria for Evaluating Market Economy Status[8]:

1. *A low degree of government influence over the allocation of resources and decisions of enterprises, whether directly or indirectly, for example, through the use of state-fixed prices, or discriminations in the tax, trade or currency regimes;*

2. *An absence of state-induced distortions in the operation of enterprises linked to privatisation and the use of non-market trading or compensation systems;*

3. *The existence and implementation of a transparent and non-discriminatory company law which ensures adequate corporate governance;*

4. *The existence and implementation of a coherent, effective and transparent set of laws which ensure the respect of property rights and the operation of a functioning bankruptcy regime;*

5. *The existence of a genuine financial sector which operates independently from the state and which in law and practice is subject to sufficient guarantee provisions and adequate supervision.*

Implications for the EU

The European Parliament Legal Service and others have argued that China should not be granted Market Economy Status in December 2016. Under this option, the EU would continue to treat China as a non-market economy and continue to apply current anti-dumping measures concerning Chinese products. However, there is a real risk that this option could place the EU in breach of its WTO obligations. If non-compliance is established, China could pursue retaliatory measures such as restricting market access to European exports to China. China has already used the WTO dispute settlement mechanism in complaints against the EU.

It is possible that the EU could try to avoid such a result by negotiating an agreement with China on the issue. Resolving the case at the various levels could take some time, which would leave space for the EU to negotiate a deal with China and delay some of the negative consequences of granting China Market Economy Status. The EU could push for an agreement on voluntary export restrictions on some of the key industries involved in anti-dumping disputes, notably steel, chemicals, and ceramics. However, this option could prove costly for growing EU-China relations. Over the last decade, China importance as a

7 "China's Economy and the WTO" (2011) The Economist http://www.economist.com/node/21541448

8 "Commission Staff Working Document on Progress by The People's Republic of China Towards Graduation to Market Economy Status" (2008) http://trade.ec.europa.eu/doclib/docs/2009/june/tradoc_143599.pdf

trade partner has grown substantially. China is currently the EU's second largest trading partner with a trade volume in excess of €520 billion in 2015, more than double the 2005 figure of €212 billion[9]. The closer the economies grow the more difficult it may prove for the EU to resolve the issue. It is possible that refusing to grant Market Economy Status could jeopardise other areas of the relationship: ongoing negotiations over the Bilateral Investment Treaty, the potential Free Trade Agreement, and growing Chinese investment in Europe, including Chinese interest in the Investment Plan for Europe. However, it is an open question as to whether China would seek such retaliatory measures and damage relations with its largest trading partner for the value of an issue affecting 1.38% of its exports to the EU[10].

Option Three: Grant China Market Economy Status with Additional Trade Defense Mechanisms

The European Commission indicated that it will fulfill its international obligations by treating China as a market economy, but only in parallel with cuts to China's overproduction and moves to strengthen the EU's trade defence instruments.

Cost Adjustment Methodology

Under Article 2(3) of the EU Basic Anti-Dumping Regulation, the EU can disregard distorted prices and costs within an industry, without regard for whether a country has Market Economy Status or a Non-Market Economy Status. Where prices are deemed to be artificially low, where there is significant barter trade or where there are non-commercial processing arrangements, the EU can employ the 'cost adjustment' method. In this situation, on a case-by-case basis, the EU can instead evaluate the normal value based on a constructed normal value or the costs of analogue countries.

This method has already been applied to cases involving Russia, Argentina and Indonesia. However, these trade partners have contested the use of the cost adjustment method at the WTO. Reportedly the WTO found the EU to be in breach of its WTO obligations in the Argentina-Biodiesel case, where the EU applied tariffs to soybeans for the production of biodiesel[11]. Decisions involving other countries are still pending. In general there is a high degree of uncertainty associated with such an option, demonstrating the limits of this approach.

Modernising EU Trade Defence Instruments

A report by the European Commission[12] put forward a number of additional measures that the EU could take to strengthen its trade defence, including (a) strengthening existing anti-dumping measures in place against China (i.e. 'grandfathering'), which would limit the possibility of interim reviews, and (b) introducing new or amended measures in anti-dumping legislation.

This option is intrinsically tied to the debate over the modernisation of the EU's trade defence measures. Although the economic environment has changed significantly over the last decade, the EU's trade defence instruments have remained largely unchanged for more than fifteen years.

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9 "European Union, Trade in Goods with China" (2016) DG Trade, European Commission http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113366.pdf

10 "Change in the Methodology for Anti-Dumping Investigations Concerning China" (2016) DG Trade, European Commission http://trade.ec.europa.eu/doclib/docs/2016/february/tradoc_154241.pdf

11 "WTO Rules Against EU in Argentina Bio-Diesel Case" (2016) EU Observer https://euobserver.com/economic/132826

12 "Impact Assessment: Possible Change in the Methodology to Establish Dumping in Trade Defence Investigations Concerning the People's Republic of China" (2016)

In 2016, in the context of global over-capacity in industries such as the steel sector, the Council recommenced discussions on a package of trade defence instruments, which were proposed by the Commission in 2013. The aim of the proposal is to modernise EU trade defence measures to adapt to changes in the economic environment and to improve their transparency, effectiveness and enforcement.

The most divisive issue in the package of proposal was to limit the use of the lesser duty rule. Under the lesser duty rule, the EU imposes duties at a level lower than the margin of dumping if this level is adequate to remove injury. In its March 2016 Communication "Steel Preserving Sustainable Jobs and Growth in Europe"[13], the Commission reaffirmed its position on the lesser duty rule by proposing its removal in certain circumstances. This rule is part of the WTO-plus commitments and it is not required by the WTO.

By limiting the use of the lesser duty rule so that it would not be applied in cases where significant distortions in the export market are found, the Commission hopes that the rule could reduce steel imports to the EU. In February 2016, the EU imposed duties between 13.4% and 16% on Chinese cold-rolled flat steel products; without the lesser duty rule the duties would have been 52.7% to 59.1% [14].

France, Germany and Italy are calling for the strengthening rules governing the safeguarding of their economies. While the UK has led a group of Member States, including Sweden and the Netherlands, in blocking the modernisation of trade defence mechanisms, arguing that it would adversely affect other parts of the value chain, as the cost would be passed on to importers, users and consumers.

As Chinese steel continues to pose an obstacle for industry and business, and as the European Parliament and Member States face growing political pressure to protect their industries, the trend towards protectionism has increased. In particular, as the UK has voted to leave the EU, it could be argued that they might no longer act as such a strong voice on the Council against enhancing trade defence instruments (TDI).

The European Parliament has already adopted its position on the issue. In 2014, it amended the Commission's proposal to make trade defence instruments even stricter so the lesser duty rule would also not apply when the exporting country does not have a sufficient level of social and environmental standards.

Despite the delay, and mounting pressure from the European Parliament and certain Member States, the Council has reportedly only restarted discussions on the issue at a technical level, making it unclear as to whether there will be a resolution on the issue by December 2016.

13 "Steel Preserving Sustainable Jobs and Growth in Europe" (2016) European Commission http://europa.eu/rapid/press-release_MEMO-16-805_en.htm

14 "Rating Agency Says Ignoring 'Lesser Duty Rule' Could Protect European Steel Against China" (2016) EurActiv https://www.euractiv.com/section/trade-society/news/rating-agency-says-ignoring-lesser-duty-rule-could-protect-european-steel-against-china/

Conclusion

China believes that the expiration of certain clauses in its WTO Accession Protocol automatically entitles it to market economy status. Although this may at first seem to be merely a technical issue, it is entangled with the politics of China's relationship with the EU and its Member States.

The European and Chinese economies have never been closer, placing much more at stake if an amicable agreement cannot be reached. On the other hand, the EU could use its importance as China's top trading partner to conclude an agreement on the Market Economy Status that best protects European interests and to negotiate concessions on items such as the Bilateral Investment Treaty. This would go some way to demonstrate the EU's nous as a negotiator and political player.

The deadline for a decision on whether to grant China market economy status is looming and the EU faces the challenge of acting swiftly and with one voice to protect European interests.

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