

December 2015

## China's Market Economy Status

### KEY MESSAGES



- 1** The question of Market Economy Status (MES) should be treated in accordance with WTO and EU rules and be based on its own merits. European business believes there is no requirement to automatically grant MES as a direct consequence of the expiry of Section 15 subparagraph (a)(ii), because the remainder of the subparagraph, parts (a) and (a)(i), remains in place.
- 2** The EU's decision-making process should be transparent and involve the European business community. China has emerged as an important player on the world scene and is a key trade and investment partner of the EU. Any decision should therefore be based on a solid and comprehensive impact assessment which takes into account China's policies and their impact on EU interests.
- 3** There are deep concerns within major parts of the European business community on what the expiry of Section 15 subparagraph (a)(ii) could mean for the EU's anti-dumping procedures and industrial competitiveness. The EU should therefore maintain effective trade defence instruments that take the real market situation in China into account.
- 4** The EU must coordinate with and take into account the positions of other major WTO members such as the United States. It is especially important that the EU avoids trade diversion of Chinese exports towards Europe as a consequence of differing views.
- 5** It is in the interest of European business that the EU strives for a sound and balanced economic relationship with China. To achieve this it is important that the EU proactively engages China through all available channels.



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## SUMMARY

This position paper does not aim at taking a position on whether or not the European Union should grant Market Economy Status to China. It does, however, weigh into the question of automaticity, and supports the view that subparagraph (a)(ii) does not create an obligation to grant MES automatically after 11 December 2016. This paper also outlines the key elements which the EU should take into consideration in its decision-making process, such as the broader economic relationship, the need for an impact assessment, and the positions of other countries. Finally, it highlights key questions and issues the EU should reflect upon.

## 1. INTRODUCTION

### PURPOSE

The purpose of this paper is to clarify the debate on China's Protocol of Accession, offer nuance, and to raise questions that BUSINESSEUROPE deems crucial for the European Commission's assessment of China's Protocol of Accession to the WTO.

There are three main elements to this debate—a legal, economic and political aspect:

- **Legal:** the first issue is how China's protocol of accession is to be interpreted, and whether or not it means that China should be granted Market Economy Status 15 years after its accession to the WTO.
- **Economic:** this revolves around the economic impact that MES would have on European jobs and business.
- **Political:** this revolves around how this decision would affect our overall relationship with China given that it is one of Europe's strategic partners and its second largest trading partner.

To achieve the purpose outlined above, this paper will focus first on the legal interpretation of China's protocol of accession, before addressing the political and economic elements.

## BACKGROUND

In recent months a discussion on China's market economy status has gained momentum in the European public sphere – among the business community, the media, within Member States and within the European institutions. This discussion has been propelled to the foreground as a direct consequence of the so-called "December 2016 deadline" for the expiry of a subparagraph in China's protocol of accession to the World Trade Organisation (WTO). The discussion revolves around what the projected



expiry of this subparagraph would mean for the determination of normal value in anti-dumping cases concerning goods originating from China by other Members of the WTO. And in particular if the expiry of this subparagraph would imply that WTO members will be obliged to use Chinese costs and prices for the determination of normal value.

Market economy is a term used to refer to countries in which costs and prices are determined by market forces undistorted by government intervention in the market.

The European Union (EU) has its own legal procedure for designating a country as a market economy for the purpose of anti-dumping. The EU evaluates this on the basis of five criteria which aim to establish whether the economic conditions in the country concerned have evolved to the extent that prices and costs can reliably be used for the purpose of trade defence investigations. The five criteria are as follows:

1. A **low degree of government influence over the allocation of resources** and decisions of enterprises, whether directly or indirectly (e.g. public bodies), for example through the use of state-fixed prices, or discrimination 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 system
3. The existence and implementation of a **transparent and non-discriminatory company law** which ensures adequate corporate governance (application of international accounting standards, protection of shareholders, public availability of accurate company information).
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.

Since China joined the WTO, the EU engaged China to allow it to demonstrate its progress toward becoming a market economy. The European Commission made several assessments in 2004, 2008, 2010 and 2011. Since then, China has not provided any new information for an updated assessment of its progress toward becoming a market economy and the Commission has not been able to carry out a further assessment.

The last assessment in 2011 recognised China's efforts to comply with all the criteria but pointed out that it met only one of five criteria and highlighted shortcomings in particular in relation to the important role of the Government in setting prices in key sectors of the economy like energy. This had a spill over effect on a number of industrial sectors in China, reducing their costs.



## 2. CHINA'S PROTOCOL OF ACCESSION TO THE WTO<sup>1</sup>

The Protocol of the accession of China to the WTO lays out the terms and conditions under which China was permitted to join in 2001. The provisions for price comparability for determining subsidies and dumping are set out in Section 15.

### 2.1 WHAT DOES SECTION 15 SAY?

Subparagraphs (a) and (d) of Section 15 set out the rules for determination normal value in dumping investigations in relation to goods originating in China. The provisions of subparagraph (a) cover to the methodologies for determining price comparability under Article VI of the GATT 1994 and the Anti-Dumping Agreement, whereas subparagraph (d) refers to the conditions for their applicability. Because of the interplay between the two subparagraphs it is not clear how normal value should be determined after 11 December 2016, when subparagraph (a)(ii) will expire in accordance with the second sentence of subparagraph (d). The implications of subparagraph (d), and in particular, how the remainder of subparagraph (a) and (a)(i) could be interpreted are addressed in this section.

#### Subparagraph (d)

In order to achieve a satisfactory answer to the interpretation of the meaning of subparagraph (a) after December 2016, it is important to examine the scope and bearing of subparagraph (d), which conditions it. The first sentence of subparagraph (d) is as follows:

***“Once China has established, under the national law of the importing WTO Member, that it is a market economy, the provisions of subparagraph (a) shall be terminated provided that the importing Member’s national law contains market economy criteria as of the date of accession.”...***

*Section 15, subparagraph (d), extract*

The first sentence of paragraph (d) highlights three important things. First, it provides China with the opportunity to prove it is a market economy without stipulating a deadline before or after which China ought to prove this. This enabled China to reach this status shortly after accession or after a longer period of time, depending on the progress made. Second, it places the burden of proof on China to prove this under the national law of the importing WTO Member. As mentioned in the background section, the EU made its first assessment on China's progress in 2004 and the last one in 2011. And third, it stipulates that the effect of establishing that China is a market economy would be the termination of the provisions in subparagraph (a).

<sup>1</sup> [Protocol on the Accession of the People's Republic of China to the WTO](#)



*“Once China has established, under the national law of the importing WTO Member, that it is a market economy, the provisions of subparagraph (a) shall be terminated provided that the importing Member’s national law contains market economy criteria as of the date of accession. **In any event, the provisions of subparagraph (a)(ii) shall expire 15 years after the date of accession.**”...*

*Section 15, subparagraph (d), extract*

The second sentence of subparagraph (d) highlights the duration of subparagraph (a)(ii), by making an explicit reference to the date upon which this clause should expire. When the first and second sentences of subparagraph (d) are examined together, there is a clear understanding that the remainder of subparagraph (a) would only expire once China has established that it is a market economy. The first and second sentence of subparagraph (d) could also be interpreted to state that the process of establishing that China is a market economy could take *longer* than 15 years.

*“Once China has established, under the national law of the importing WTO Member, that it is a market economy, the provisions of subparagraph (a) shall be terminated provided that the importing Member’s national law contains market economy criteria as of the date of accession. In any event, the provisions of subparagraph (a)(ii) shall expire 15 years after the date of accession. **In addition, should China establish, pursuant to the national law of the importing WTO Member, that market economy conditions prevail in a particular industry or sector, the non-market economy provisions of subparagraph (a) shall no longer apply to that industry or sector.**”*

*Section 15, subparagraph (d), in full*

The third and final sentence of subparagraph (d) creates provisions for China to obtain market economy status in a particular industry or sector. Similar to achieving overall market economy status, the third sentence also places the burden of proof for establishing market economy status in a particular industry or sector on China. Market economy status can thus be granted partially, sector per sector, depending on the proof offered by China.

### **Subparagraph (a)**

Subparagraph (a) concerns the methodologies to be used for determining the normal value in anti-dumping investigations for goods originating from China for the duration that China is considered a Non-Market Economy (NME). It consists of three provisions: subparagraph (a), (a)(i) and (a)(ii). Provision (a)(ii) is set to expire according to subparagraph (d).



- (a) *In determining price comparability under Article VI of the GATT 1994 and the Anti-Dumping Agreement, the importing WTO Member shall use either Chinese prices or costs for the industry under investigation or a methodology that is not based on a strict comparison with domestic prices or costs in China based on the following rules:*
- (i) *If the producers under investigation can clearly show that market economy conditions prevail in the industry producing the product with regard to the manufacture, production and sale of that product, the importing WTO Member shall use Chinese prices or costs for the industry under investigation in determining price comparability;*
  - (ii) *The importing WTO Member may use a methodology that is not based on a strict comparison with domestic prices or costs in China if the producers under investigation cannot clearly show that market economy conditions prevail in the industry producing the like product with regard to manufacture, production and sale of that product.*

*Section 15, subparagraph (a), in full*

Currently, the EU appears to use subparagraph (a)(ii) as a legal basis for the analogue country methodology for determining normal value. The analogue country methodology uses the costs and prices of a producer in a third country to determine the normal value for the producers in China unless those producers can demonstrate that they are entitled to market economy treatment.

- (a) *In determining price comparability under Article VI of the GATT 1994 and the Anti-Dumping Agreement, the importing WTO Member shall use either Chinese prices or costs for the industry under investigation or a methodology that is not based on a strict comparison with domestic prices or costs in China based on the following rules:*
- (i) ***If the producers under investigation can clearly show that market economy conditions prevail in the industry producing the product with regard to the manufacture, production and sale of that product, the importing WTO Member shall use Chinese prices or costs for the industry under investigation in determining price comparability;***

*Section 15, subparagraph (a), after expiry of subparagraph (ii)*

After the expiry of provision (a)(ii), it is important to assess what the remainder of subparagraph (a) means. Part (a) states that the measures used by WTO Members to determine normal value should be *based on* the rules specified in subparagraph (a). As mentioned above, the provision specifying the use of additional methodologies if Chinese producers cannot show that market economy conditions prevail (a)(ii), will expire at the end of 2016. The remaining provision, (a)(i) states that WTO Members should use Chinese prices when Chinese producers can demonstrate that market economy conditions prevail in their sector. This raises several important issues:



- Does the expiry of subparagraph (a)(ii) remove the *blanket use* of additional methodologies in determining normal value for price comparability in case Chinese producers cannot establish that market economy conditions prevail in their sector or industry?
- Does it remove the burden of proof on Chinese producers to demonstrate market economy conditions prevail in cases in which additional methodologies for price comparability are used?
- The remainder of subparagraph (a) commits WTO Members to use Chinese prices only in cases where Chinese producers can demonstrate that market economy conditions prevail in their sector or industry.

## 2.2 WHAT DOES THIS MEAN?

The above analysis of China's protocol of accession to the WTO shows that the interpretation of Section 15 is neither simple nor singular. The most important conclusion is that a distinction can be made between the EU's compliance with the WTO protocol of the expiry of subparagraph (a)(ii), and its decision on China's Market Economy Status. The protocol clearly provides scope for treating the two issues separately. A crucial aspect upon which the EU should reflect is what the remaining part of subparagraph (a) means for the determination of normal value in anti-dumping investigations. In sum:

- The expiry of subparagraph (a)(ii) does not mean that the EU should or should not grant Market Economy Status to China. This is a decision that should be taken independently from the expiry of subparagraph (a)(ii) at the end of 2016.
- The expiry of subparagraph (a)(ii) might limit the scope of but does not rule out the use of alternative methodologies altogether. The remainder of subparagraph (a) could provide scope for a limited use of additional methodologies and the EU should explore this further. Subparagraph (a) only refers to the rules upon which measures should be *based*, as opposed to specifying what those measures should be.

Although linking the expiry of subparagraph (a)(ii) to granting Market Economy Status is not clearly supported by Section 15, doing so would also go against subparagraph (d) and the EU's process of allowing China to demonstrate its progress toward becoming a market economy. The decision to grant Market Economy Status also does not have a clear deadline and should be based on reasons other than the expiry of subparagraph (a)(ii) in China's protocol of accession to the WTO.

## 2.3 IMPACT ON TRADE DEFENCE INSTRUMENTS

The expiry of subparagraph (a)(ii) will likely have an impact on the EU's trade defence instruments, and the way and scope for which they might be used. In order to ensure that the EU is ready to deal with whatever the impact might be, it is important that the Commission explores the following questions in parallel to its evaluation of the meaning of China's Protocol of Accession:





- Would the expiry of subparagraph (a)(ii) impact the ability of the EU to defend itself against dumping from China?
- Would our current trade defence instruments suffice to defend against dumping?
- Should the EU develop additional instruments or improve its current instruments after the expiry of subparagraph (a)(ii), or will anti-subsidy measures suffice to address market distortions?

The solution found should be in line with WTO rules and at the same time allow the EU to continue to use a methodology to determine the normal value in anti-dumping cases that takes the real market situation in a given sector or company in China into account.

#### **Trade defense - some data**

Last year the Commission initiated sixteen new cases, the highest number since 2010 with 18 cases. As of 30 November 2015, there were 87 anti-dumping cases and 22 anti-subsidy measures were in place. 53 of the anti-dumping and 5 anti-subsidy measures are in place against China. 10 new investigations have been launched since the beginning of 2015, targeting China in 5 cases.

The largest number of EU trade defense cases and measures concern iron and steel. European chemicals and, increasingly, energy industries (solar panels, biofuels) are also among the main sectors using the instruments. The EU is the third largest user of trade defense instruments in the world.

### **3. ADDITIONAL ELEMENTS THAT THE EU SHOULD TAKE INTO CONSIDERATION**

#### **3.1 BROADER ECONOMIC RELATIONSHIP**

The discussion on the expiry of Section 15 subparagraph (a)(ii) of China's Protocol of Accession should also be viewed in the context of the EU's broader economic relationship with China. First, there has been no further assessment of China's progress toward becoming a market economy since the new government came into power in late 2012. It is therefore unclear what impact the various policy initiatives the new Chinese government has launched have had on China's transition from a non-market to a market economy. However, according to the European Union Chamber of Commerce in China<sup>2</sup>, the 2013 Third Plenum and the changes and reforms that were supposed to derive from this have not yet been implemented, especially regarding market access opening. Second, the Commission's new Trade Strategy speaks of 'rebalancing our relationship with China in a mutually beneficial way'.<sup>3</sup> The interpretation of China's Protocol on Accession should be examined within this wider policy objective. The Chinese government provides strategic direction to many areas of

<sup>2</sup> European Union Chamber of Commerce in China, *European Business in China – Position Paper 2015/2016*, September 8, 2015.

<sup>3</sup> Directorate General for Trade, *Trade for All: Towards a more Responsible Trade and Investment Policy*, Oct. 2015, p. 31





its economy, and it would be important to assess what kind of impact this has on our economic relationship with China.

If DG Trade wishes to rebalance the EU's relationship with China in a mutually beneficial way, it must ensure effective internal policy coordination across the European Commission and make optimum use of instruments such as the Industrial Policy Dialogue, the High-Level Economic and Trade Dialogue, and the Joint Committee on Trade to address horizontal and specific issues.

In view of the broader economic relationship, BUSINESSEUROPE wishes to re-underline the priority issues that should be addressed by China in its reform process:

- implementation of market economy principles and in particular compliance with Section 9 of the Accession Protocol requiring prices to be set only by market forces;
- avoidance of governmental interference in the decision-making of companies;
- elimination of discrimination or unjustified restrictions, both for domestic and foreign operators;
- transparency of fiscal instruments and application of national treatment principle;
- enforcement of basic legal principles and in conjunction with WTO law (notably on IPR, standardization or certification, services regulations, public procurement, notification of state-supported investment programmes, financial guarantees and subsidies to Chinese companies);
- continued reform of the Chinese financial sector;
- effective enforcement of company law and international accounting standards.

### **3.2 THE NEED FOR AN IMPACT ASSESSMENT**

The EU should conduct an impact assessment of the possible changes flowing from the expiry of subparagraph (a)(ii) in order to assess the effects of the different policy options. This assessment should also take into account the impact of a possible increase of Chinese exports, and whether the impact on jobs and industry would differ strongly across the EU.

The Chinese economy is also experiencing slowing growth and features overcapacity in most of its industrial sectors. This overcapacity could grow in the near future and China will continue seeking export markets for its products even if domestic demand would increase. It is also important to examine how the 13<sup>th</sup> five-year plan intends to address this. Overcapacity in the Chinese economy will pose a challenge for the EU at a time when it is faced with the implications of the expiry of subparagraph (a)(ii) of China's protocol of accession. Whatever the outcome of the EU's process of deliberation will be, it is in the interest of all business that the EU maintains a balanced economic relationship with China.



### 3.3 POSITIONS OF OTHER COUNTRIES

Other WTO Members are also required to evaluate the meaning of China's protocol on accession. BUSINESSEUROPE strongly recommends that the EU engages with key partners to exchange views on this issue and duly takes into account its global trade implications. The European Parliamentary Research Service recently released a report in which it analyses the positions of the United States, India, Mexico, Canada and Japan.<sup>4</sup>

While the United States government has not yet taken a position on how to interpret China's Accession Protocol, it has huge discretion on whether or not to grant and subsequently revoke MES as it is up to the administration itself to take a decision. This also places the United States in a unique position. India and Mexico, however, have apparently issued no formal statement regarding their position and India does not have any obligation in its legal framework to grant market economy status to China. Canada, exceptionally, incorporated a provision in 2002 to grant automatic MES to China in 2016, which it subsequently repealed in 2013. Japan, a rare user of anti-dumping measures, has not yet decided their position but in 2007 guidelines were released that recommend granting market economy status to China by the end of 2016.

#### WHY DOES IT MATTER?

European industry would be adversely affected if the EU were to consider China as a market economy and other important WTO members such as the United States would take a different decision. It would most likely lead to an increasing number of imports from China. This would put additional pressure on European producers as opposed to their competitors in other parts of the world. Equally, the EU should also consider what the possible consequences might be if it were the only major economy to continue treating China as a non-market economy. It is therefore important that the EU commences informal talks with key partners to try to coordinate their positions. A coordinated approach is also matters to end users, because it is important that they have a choice of suppliers and a degree of negotiating power.

Finally, it is also important that the EU considers whether its assessment of China's Accession Protocol could have an impact on the EU's trade negotiations with other countries.

### 4. ADDITIONAL QUESTIONS / ISSUES THE EU SHOULD REFLECT UPON

- Would the EU have effective instruments for rebalancing its economic relationship with China after a possible amendment of anti-dumping legislation?
- How does the EU intend to address the overcapacity in many industrial sectors within the Chinese economy?
- How will the EU continue striving for a level playing field with China in the future?

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<sup>4</sup> European Parliamentary Research Service, *Granting Market Economy Status to China: An Analysis of WTO law and of selected WTO members' policy*, November 2015.



- Would the outcome of the EU's assessment on China's Protocol of Accession have an impact on its trade negotiations with other countries?
- In general, the EU should also engage other countries bilaterally and multilaterally to strengthen rules in key areas such as subsidies, competition, State Owned Enterprises (SOEs) and Intellectual Property Rights (IPR) in order to strengthen the global trading system.