



Towards China's Market Economy Status

A Powell Tate Report

Introduction

This year will see the world's three largest economies become increasingly entangled in a complex trade tussle with considerable political ramifications. China has requested that the European Union (EU), the United States (U.S.) and other Members of the World Trade Organisation (WTO) give effect to the expiration of a provision agreed in the country's WTO Accession Protocol. Beijing believes that this involves the automatic granting of Market Economy Status (MES) by December 2016. As a result, the anti-dumping instruments currently available to countries importing Chinese products would be weakened.

Obtaining MES is however no straightforward process. WTO protocols do not grant MES, nor do WTO rules specify the technical criteria for identifying a market economy. Granting the status effectively comes down to each individual WTO member and how they implement the changes to the Accession Protocol into domestic law. Faced with this lack of agreed decision-making procedure, as well as legal uncertainty over the interpretation of the Protocol, politics has become the deciding factor.

Despite China's determination on the matter, the U.S. is, in principle, opposed to recognising China as a market economy. It has been actively lobbying the EU, which has yet to agree on its position, to follow suit. The political and diplomatic debates are taking place in a complex environment, where legal reservations meet sensitive geopolitical and commercial concerns, leading China, the U.S. and the EU to very different and potentially irreconcilable positions.

Understanding these various perspectives is key for any business operating in this environment. In the report which follows, Powell Tate attempts to break down the legal, economic and political variables at play between the three trading blocs, providing an outlook for what may be to come.

Why does this matter?

- This is about ensuring a level playing field in international trade competition. When importing goods, an individual country will want to ensure that the price accurately reflects the production costs involved. Dumping takes place when manufacturers export goods to a third country at a price below its home market price or below the cost of production. An anti-dumping investigation compares the prices of the country accused of dumping with the prices of the product in the importing country. Any price difference is referred to as the dumping margin.
- The direct relevance of MES lies in the determination of dumping margins and the scope that importing countries have for conducting anti-dumping investigations. In the assessment of dumping margins when importing from non-market economies, domestic prices are considered unreliable due to state intervention.
- A derogation allows the importing country to use alternative methodologies (i.e. data from a market economy country, the so-called "analogue country") to calculate the dumping margin, which generally increases anti-dumping investigations and anti-dumping duties. In the case of China, this derogation expires at the end of 2016.

An Australian Perspective

For Australia the debate in the US and EU over recognising China as a market economy appears arcane. After all, Canberra granted MES to China 10 years ago as part of the Free Trade Agreement (FTA) negotiations with Beijing. Since then there has been little evidence of an increase in dumping by Chinese firms or difficulty proving dumping cases. At the same time our trade has continued to grow – and grow phenomenally.

This then begs the question of whether it should matter to Australia if the EU and US do not extend MES status to China. Surely it will have little effect on us if they do not?

Indeed, it could be said there are few implications for Australia if China is not granted MES by either or both of the “super-markets”. After all, China has not enjoyed market economy status in the EU and US markets previously. And during the past decade since Australia granted China MES status, we have negotiated an FTA with Beijing and seen two-way trade grow substantially. Bilateral trade with China is worth in excess of \$150 billion today and comprises one-quarter of our total trade with the world.

The counter to this, of course, is that if the EU and US granted China MES status we might see much stronger growth in world trade. Arguably the world would see less antidumping cases against Chinese exporters, which would increase confidence amongst Chinese companies about exporting to the US and EU. The global economy, including Australia's economy, would surely benefit from the corresponding rise in international trade and global economic activity.

Further, if China were granted MES it would make accession to the Trans-Pacific Partnership (TPP) deal easier in future. China has moved in recent

years from hostility to the deal (which Beijing previously saw as an attempt to contain China), to a more favourable position in recent years. Indeed, given the gains TPP holds out for Asia-Pacific trade, China may well want to join this exclusive club in future. MES recognition by the US would make Chinese accession to the TPP easier.

Furthermore, both MES by the US, EU and other WTO member countries (together with possible future membership of the TPP) would in turn increase pressure on China to undertake much needed economic reform. If economic reform were implemented China would be able to develop a consumer-based market economy much faster. This is in the interests of both the US and the EU – as well as the rest of the world – as it would help create a third super-market and third prong to the global economy, mitigating the global impact of future economic shocks to any one of those prongs. (For example, if a strong domestic consumer market existed in China at the time of the Global Financial Crisis, most of the rest of the world would not have been as harshly impacted by the crisis. Indeed, Australia largely rode out the GFC because of China's demand for its resources. Imagine the potential impact of greater domestic Chinese demand for the world economy.)

In short, it is in Australia's interest – as well as that of the rest of the world – that the US and EU both grant China MES. However, domestic politics in both those markets might determine otherwise. It is therefore contingent upon our government and diplomats to make the case for the US and EU to extend MES to China. The alternative is a lower growth trajectory for the world economy – and by extension for Australia.

Current legal context

- **WTO Accession Protocol:** When China acceded to the WTO in 2001, it was categorised as a non-market economy. Trading partners were allowed more flexibility to use their trade defence instruments, especially anti-dumping measures. It was agreed in the Accession Protocol that after a transitional period of 15 years, this flexibility would be restricted. Beijing interprets this arrangement as an automatic right to MES after the transitional period.
- **Country-specific clauses:** Under standard WTO rules, the importing country can identify dumping by proving that the state authority in the exporting country executes a “complete or substantially complete monopoly of its trade (...) where all domestic prices are fixed by the State”. Due to the wide scope of this definition, specific clauses were negotiated with China in its Accession Protocol.
- **Legal process:** Because WTO protocols do not grant MES, there is no legal process in place at the level of the WTO. The relevant provisions in China’s Accession Protocol refer instead to national rules for criteria defining market economies. Chinese exporters must prove that they produced their goods under market conditions, according to the criteria outlined in the laws of the importing country.
- **Different approaches:** Various countries are already treating China as a market economy, including Australia and South Africa, often as a trade-off in the context of free trade agreement negotiations. A number of other large economies do not, including the U.S., EU, Canada, Japan, Mexico and India. This variety of legal approaches further politicises the decisions to be taken in Washington and Brussels.

Possible scenarios

The uniqueness of this situation means that the possible outcomes are varied. The European Commission’s public consultation has outlined the following possibilities:

1. Business as usual:

The EU and the U.S. stick to their current approach. China could then take them to the WTO Dispute Settlement Body to challenge the validity of their interpretation. Reaching a verdict would be a lengthy process, buying the EU and U.S. time to refine their trade defence instruments. This could inject new momentum into a reform proposal on EU Trade Defence Instruments, which has been under discussion by EU Member States since 2013.

2. Giving in:

This would involve removing China from the list of non-market economies in EU/U.S. anti-dumping legislation, requiring a legislative proposal to amend domestic law. However, the potential effect of lowering trade defences on certain industries and jobs will make such a legislative change politically difficult to sell in those jurisdictions.

3. Adopting a new anti-dumping instrument:

Depending on the type of instrument, this option could allow the EU/U.S. to avoid a WTO dispute settlement, protect vulnerable industries, and maintain good relations with China all at once.

Securing long-term growth

International trade policy is first and foremost about economics, with individual countries seeking to gain access to foreign markets while protecting their industries back home. Each market consequently sees the issue from a very different macro-economic context. Then again, as each other's primary trading partners, the three economies are interlinked with one another like never before.

Transitioning economy in China

- Currently transitioning from a manufacturing to a service economy, 2015 saw China's economy growing at its slowest rate in 25 years, while the country's industrial profits experienced a seventh consecutive month of decline last January. KPMG outlines in its [China Outlook 2016](#) that the country presently has a two-track economy, with one track composed of basic manufacturing and another of services, advanced manufacturing and consumer spending.
- Whereas the second track has exhibited strong growth, the first track is struggling with weakening global demand and manufacturing overcapacity. This has forced China to depend to a large extent on investment into large-scale infrastructure projects rather than export. Initiatives such as the Asian Infrastructure Investment Bank, the BRICS Bank and the "One Belt, One Road" initiative, are among the instruments used to access new markets and boost demand.

Stagnating EU

- The EU's economy is considered fragile at best. The EU juggles a myriad of policy objectives which are difficult to reconcile: it must protect jobs at home while securing economic growth in a high-cost environment, and soothe inward-looking populist movements while also enhancing its global footprint.
- The EU cannot afford to strain relations with China, not in the least for the country's foreign direct investment into the EU and the investment opportunities its market offers for European companies. Then again, the EU must also protect its own domestic industries against unfair international competition.

Some optimism in the U.S.

- The U.S. economic picture has improved but growth remains uneven across geographies and industry sectors. Trade has emerged as a major policy issue in the U.S. presidential and congressional elections, with public support for trade agreements declining and criticism of Chinese trade and currency policies increasing. As with immigration, the topic of trade puts a foreign face on the economic uncertainty many Americans feel.

Implications for trade negotiations

The three global powers are all seeking to address their individual economic situations. The issue of MES will therefore be positioned as a means of either protecting or enhancing the respective external trade outlooks.



China is focused both on securing growth and speeding up internal reforms. To Beijing, exports are not merely products, but are often part of infrastructure diplomacy, as highlighted above. The need to export excess manufacturing capacity is an inherent part of **the country's 'Going Out' strategy** and gaining MES could provide new impetus to this.

In Washington and Brussels, **bilateral trade is partially driving the political agenda**. The U.S. is keen to reduce its trade deficit with China, which reached around \$365 billion (€331 billion / ¥2.381 billion) in 2015. For the EU, rebalancing its trade deficit of \$198 billion (€180 billion / ¥1.295 billion) is also a priority, although the picture is slightly different here. Whereas China is negotiating a Bilateral Investment Treaty with both the U.S. and the EU, the Treaty is especially key for the EU due to its urgent need for foreign direct investment. The debate over MES is a potential obstacle to the rapid conclusion of these negotiations.

In the long-term, **recognising China as a market economy could have implications for other international negotiations and China's future geopolitical position**:

- Once treated as a market economy, China will have a stronger and more equal position within other trade-related negotiations. Being recognised as a market economy is therefore an important element of its global outreach strategy, and Beijing firmly believes that this is just a matter of time.
- In the U.S., changing how China is treated in anti-dumping proceedings could cost the Obama administration the Congressional support it needs to ratify the Trans-Pacific Partnership deal.
- For the EU, which is already struggling to gain popular support for its trade negotiations with the U.S., further antagonising some Member States and Members of the European Parliament by recognising China as a market economy could backfire.

Jobs and anti-dumping... and jobs

Beyond global economics, the political reality is driven by short-term industrial issues. The **increase in anti-dumping cases against China** highlights the depth of sectorial concerns in third countries, including the EU and U.S. The U.S. Department of Commerce is currently investigating the largest number of anti-dumping and countervailing duty cases against China in 15 years, involving steel, appliances, paper and tyre industries. As of November 2015, 53 out of the EU's 87 anti-dumping cases concerned China, primarily involving iron and steel manufacturing but also chemicals, solar panels and biofuels.

In both the U.S. and the EU, dumping of excess steel from China has become conflated with the discussion on the MES, even though excess capacity is a more widespread phenomenon in China. The EU Chamber of Commerce in Beijing published a [report](#) in March 2016 which highlights evidence of overcapacity in China's crude steel, electrolytic aluminium, cement, chemicals, oil refining, flat glass, shipbuilding, and paper industries.

Brussels and Washington DC are looking at this issue through the lens of employment. **Evaluating the potential micro-economic effects** in a preliminary assessment, the European Commission found that between 73,300 and 188,300 jobs would be at risk if no mitigating measures are imposed once China is treated as a market economy in anti-dumping proceedings. These jobs are mostly concentrated in Italy, Germany, Spain, France, Portugal and Poland. The Economic Policy Institute's [recent calculation](#) includes the indirect impact on jobs in

the value chain, concluding that cheaper imports from China could jeopardise between 1.7 and 3.5 million jobs in the EU.

Potential gains?

There are, however, various **considerations that shed a more nuanced light on the matter:**

- There could be job gains. Manufacturers such as the European car industry who process crude steel further downstream might experience lower material costs, which could decrease consumer prices, boost demand and generate jobs in other sectors. The [U.S.-China Business Coalition](#), which represents more than 200 U.S. companies in China, urged the U.S. to start treating China as a market economy within 2016, calling it a "step to build confidence in the bilateral relationship."
- It will not solve China's overcapacity problem. While MES could smoothen China's overcapacity by increasing exports, only some of the sectors which could benefit the most (including chemicals, iron and steel) are currently affected by anti-dumping measures.
- The macro-economic impact could be limited. When it comes to the overall bilateral trade with China, EU and U.S. anti-dumping investigations only cover a small number of products from China.

Regardless, considering the sluggish economic growth outlook for all three global powers, **every job loss has important political**

ramifications for governments. The political importance of protecting jobs shows that any decision on the MES issue in Washington DC and Brussels may be driven more by politics, linked to industrial implications, than macro-economic considerations.



It's all about politics

Politics remains the ultimate test in this global debate. **In international trade, the politics are primarily local**, as any decision or agreement must be sold to national audiences. This is particularly relevant in the West in light of electoral cycles, but the impact of public opinion should not be downplayed in China. Indeed, Beijing's political legitimacy rests on driving economic performance and securing global recognition.

For Beijing, much rests on the fundamental belief that **China must return to its rightful place** in the global economy:

- China's leaders attach political significance to MES, seeing it as a status symbol vis-à-vis other powers, particularly developed economies such as the U.S. and the EU.
- Beijing considers it an automatic right after the 15-year transitional period. Being denied MES would be perceived as unjust since Russia and the Ukraine were granted MES in 2002 and 2006 respectively, even though they arguably did not constitute market economies.
- China has especially high expectations vis-à-vis the EU. When China applied for WTO membership, the EU was, albeit after long negotiations, the first to extend its endorsement.

In the U.S., the Obama administration is in its final year in office and a breakdown in bilateral relations with China would be an undesirable legacy. **Washington must therefore strike a**

delicate balance in its bilateral economic discussions with China:

- The U.S. is urging Beijing to implement structural reforms which would help the country transition from an export-led to a consumption-led economy, which it believes would rebalance the trade deficit. On the other hand, the administration is under pressure from companies, trade groups and unions not to weaken its trade defence instruments and to nudge China away from interventionist policies. The U.S. aluminium and textile sectors have allied with the steel industry to oppose China MES.
- This is an election year for both the Presidency and Congress, one in which many voters are worried about the impact of trade on their jobs and communities. U.S. competitiveness, including the issue of U.S.-China commercial ties, is a topic of much debate, and the majority of candidates on both ends of the political spectrum broadly oppose any automatic treatment of China as a market economy.

Further removed from electoral politics, **Brussels can take a more pragmatic approach** and focus on how the issue may serve other purposes:

- The need to facilitate Chinese foreign direct investment in the EU to reinvigorate its fragile economy is a key opinion influencer. At a high-level bilateral summit last year, China pledged to invest in the European Commission's €315 billion Investment Plan

and to link it to the country's own "One belt, One Road" initiative.

- As a body of institutions, the EU is keen to be considered a fully-fledged international actor. The issue of MES could therefore be seen as a litmus test, particularly given how EU Member States sometimes challenge the Commission's role as an international trade negotiator and are often tempted to deal bilaterally with third countries.
- The path to a common position will be complex, as the EU seeks to reconcile the short-term interests of individual Member States, potential pressure from China, and the need to strengthen its position in the global trade regime.



Outlook

As it currently stands, the prospect of any quick agreement between the three economies is becoming increasingly implausible. In summary:

- Beijing's official position towards MES has been straightforward from the start. Simply put, China should automatically be granted MES under WTO rules at the end of this year. Furthermore, it should not be subjected to additional criteria not stipulated in its Accession Protocol, such as the domestic criteria currently used to determine what constitutes a market economy in the U.S. and the EU.
- The Obama administration is taking a position of non-action. The U.S. Department of Commerce says it will not automatically grant MES but instead consider if China meets the statutory criteria for doing so in the context of individual anti-dumping cases. The administration says there is no provision in U.S. law that requires China to be treated as a market economy for anti-dumping purposes after December 2016. In fact, the U.S. would prefer China to bring a challenge to the WTO, which would put the onus on Beijing to prove that its economic model is meeting the criteria of a market economy.
- The EU has yet to define its position. An opinion from the European Commission's legal service stated that the EU is obligated under WTO law to take China off its list of non-market economy countries in December. The Commission would have to submit a legislative proposal to the co-legislators; the Council of the EU, which represents the government

of its Member States, and the European Parliament. Considering how politically charged this debate is, a pro-China compromise will be difficult to reach.

A divided EU

Among **EU Member States**, pro free trade countries such as the UK, the Netherlands and Scandinavian countries support treating China as a market economy in anti-dumping proceedings. Member States such as Italy and Spain, who stand to lose most, are broadly opposed. Germany may tip the scale either way. The outcome of the UK's upcoming referendum on whether to leave the EU may also influence the debate.

Discussions in the **European Parliament** are also gathering pace. Several political groups have adopted a position, generally calling on the Commission to maintain the robustness of its trade defence instruments. Moreover, in response to the Commission's public consultation on the issue, a group of Members of the European Parliament formed an "MES China Action Group" and launched a counter-consultation.

- Adding further complexity is the need for the EU and the U.S. to coordinate with key WTO members such as Japan. Should either decide to accept China as a market economy and lower its trade defences, it will be crucial to prevent unwanted trade diversion of Chinese exports.

Expect the unexpected

Economic and political debates on trade should never be seen in isolation. They always take place in a broader diplomatic context. As highlighted at the outset, continuing with business as usual may lead to **retaliation from China**.

Beyond the prospect of a case at the WTO Dispute Settlement Body, Beijing could also consider **retaliation in other areas**, whether in the context of security issues in the Korean Peninsula or the Middle East, the implementation of the Paris Climate Agreement, or a straightforward ban on specific companies from entering its market. Such diplomatic tensions could also have negative ramifications for China. Straining bilateral ties could for example boost EU-U.S.-Japan cooperation in shaping the global trade system, as they remain committed to salvaging their position as global standard-setters.

Alternatively, the decision could also boil down to a **diplomatic horse-trading exercise** with other peripheral issues dear to both the U.S. and the EU. In many ways, their position on China's MES will relate to how much each government values the importance of their bilateral relations at any given time. What is clear, however, is that while any course of action may need to be grounded in legal arguments and wrapped in an economic narrative, it will ultimately be a political decision.



With a global footprint, including offices in government centres such as Beijing, Washington DC and Brussels, Powell Tate is well positioned to help stakeholders navigate this complex political environment. Our historically robust trade practice has been advising clients across the globe on a large range of international trade issues.

With an expertise in trade analysis, trade-specific messaging, policy-maker and policy media engagement strategies, and a network of contacts to match it, Powell Tate is ideally placed to help you raise your concerns with decision-makers in relevant markets.

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