

SPECIAL ISSUE

TIME'S UP: CHINA'S COMING BATTLE FOR MARKET ECONOMY STATUS

ABOUT

The Chinese have long been obsessed with strategic culture, power balances and geopolitical shifts. Academic institutions, think-tanks, journals and web-based debates are growing in number and quality, giving China's foreign policy breadth and depth.

China Analysis, which is published in both French and English, introduces European audiences to these debates inside China's expert and think-tank world and helps the European policy community understand how China's leadership thinks about domestic and foreign policy issues. While freedom of expression and information remain restricted in China's media, these published sources and debates provide an important way of understanding emerging trends within China.

Each issue of *China Analysis* focuses on a specific theme and draws mainly on Chinese mainland sources. However, it also monitors content in Chinese-language publications from Hong Kong and Taiwan, which occasionally include news and analysis that is not published in the mainland and reflects the diversity of Chinese thinking.

Introduction by François Godement

This special issue of *China Analysis* focuses on expert and media views from China on the issue of granting Market Economy Status (MES) to China, and is paired with an ECFR brief about European views on the same topic.¹ The sources dissected here by Agatha Kratz reveal some commonalities, but also some sharp differences between the Chinese and the European perspectives.

Among the points in common is a general sense of recognition that market conditions in China and the state of play as regards economic reform leave much to be desired. This is likely to make the granting of MES more difficult. Another point of agreement, at least for some of the Chinese authors, is the recognition that Article 15 of China's Accession Protocol to the World Trade Organization (WTO) is unclear, leaving open the possibility that special methodologies for anti-dumping measures will remain in place after 2016. Some of the experts distinguish between the granting of MES and the issue of anti-dumping measures, although they do seem to think that ending the special criteria applied to China would de facto end anti-dumping. Finally, by the beginning of 2016, Chinese authors had identified some likely stands that certain European member states would take.

But then come the differences. Article 15 and the "surrogate country" method, which allows WTO countries to compare

¹ François Godement, "China's Market Economy Status and the European Interest", European Council on Foreign Relations, June 2016, available at <http://ecfr.eu>.

Chinese prices with those of a third country to identify unfairly low prices, is viewed as discriminatory, although it was an integral part of the agreement signed by China. The Chinese experts seem to think that only Europe and the United States have so far failed to grant MES, whereas in fact India, Mexico, Japan, and many others have yet to do so – but the authors may be right that the European and American decisions will have a larger impact. Most of all, their policy advice to China in almost all cases does not mention a negotiating process, but instead is built around lobbying, with business partners, bilaterally with amenable member countries (including “undecided” Germany), and at the level of the European Union. There is no mention of any social issues in Europe resulting from Chinese dumping practices. Steel receives only one fleeting mention. In fact, the need for more market reforms in China is more often cited than any consideration that Europe might have.

While Europe is often said to be overly absorbed with its own crises, this self-centred Chinese vision, even if it stems from the traditional consideration of China as a developing economy and from perceptions of “unfair” treatment, is a cause for concern. In spite of the uncertainties on the horizon for the EU, China may be overstating Europe’s internal divisions, overrating the effectiveness of its own lobbying after the Asian Infrastructure Investment Bank Blitzkrieg, and underestimating Europe’s resilience when it comes to fundamental economic and trade issues.

China's Market Economy Status: The all-out push for recognition

Agatha Kratz

This year, 15 years after China's accession to the World Trade Organization, the European Union will have to rule on whether or not to grant Market Economy Status (MES) to China.² It would have a significant impact on bilateral trade, and also bears symbolic significance regarding China's place in the global order. It is likely to be an intense year of debate in the EU, not least because of China's economic weight and the impact of its exports on Europe's economy. The debate on MES is also gaining momentum within China. It is not so much about whether or not China is entitled to get MES, but rather about how to make sure it does. Chinese observers are expecting tough relations between China and the EU on this issue, and are therefore devising multi-pronged strategies for the struggle ahead.

Defining the problem

Article 15 and its hidden cost for China

The Chinese observers all begin by describing what this year's debate concerns: namely Article 15 of China's accession protocol to the WTO, clause (a)(ii) of which allows "non-market economy" treatment of China.³ This means that in anti-dumping⁴ cases launched against China by WTO members importing Chinese goods, if the Chinese producers under investigation are unable to prove that they are operating under "market economy conditions", WTO importers are permitted to use "surrogate country" prices, rather than Chinese ones, to determine the extent of dumping and the appropriate level of anti-dumping duties. The provisions of the clause are set to expire this year, and many in China believe that this should mean that the country is automatically granted MES. However, although many WTO countries have already been granted MES, the EU and the US have yet to make a decision.

2 For additional details, see François Godement, "China's Market Economy Status and the European Interest", ECFR Policy Brief, June 2016.

3 See the full text of the accession protocol, WT/L/432 Accession of the People's Republic of China: Decision of 10 November 2001, World Trade Organization, 23 November 2001, available at <http://docsonline.wto.org/imrd/directdoc.asp?DDFDocuments/t/WT/L/432.doc> (hereafter, WTO, WT/L/432).

4 Dumping occurs when the price of a product sold in an importing country is below this product's price in the market of the exporting country. Dumping is complex to measure, which often requires complex analyses.

Article 15 Clause (a) reads (see WTO, WT/L/432):

"(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 like 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."

Clause (a)(ii), as Chen Qin explains, was the result of a compromise reached after bitter discussions between China and WTO members on the level of state intervention in China's economy.⁵ However, Chinese observers complain that the clause has unfairly penalised Chinese companies since China's accession to the WTO in 2001. Li Siji, Yao Yuan, and Tu Xinquan say that importing countries using this clause have enjoyed an "enormous degree of freedom" in choosing a surrogate country to determine the appropriate extent of duties in anti-dumping cases.⁶ This has usually led to unfairly high levels of duties, which has hurt Chinese exporters.⁷

Moreover, Li Zhongzhou says that while the wording of the clause is not punitive in itself, it has clearly been implemented in such a way.⁸ As public data cited in *Caixin Weekly* shows, China is the main target of all global anti-dumping cases, with 63 lawsuits on anti-dumping charges in 2014 alone – way ahead of the two other closest countries – South Korea with 18, and India with 15.⁹ The commentators do not acknowledge the possibility that this could be the result of China's particularly skewed economic environment.¹⁰ Instead, Li and Bai Ming contend that the US and the EU have used the clause relentlessly, as an excuse to levy duties on China to "an absurd degree".¹¹ Li, Yao, and Tu believe that the US has used the clause as one more way to contain China's development and economic progress. Li Zhongzhou thinks the result was simple "discriminative trade protectionism" (歧视性贸易保护主义, *qishixing maoyi baohu zhuyi*) on the part of the EU and the US, who sought to defend their own industries while blaming China for their economic difficulties at home, especially since the 2008 crisis.

Bai says that entering the WTO provided China with a great opportunity to participate in globalisation, but that accepting Article 15 also entailed a high "hidden cost" (隐性成本, *yinxing chengben*). Wu Xiangning says that in the

5 Chen Qin, "China's struggle to enter WTO rises again" (中国“入市”之争再起, *Zhongguo "rushu" zhi zheng zai qi*), *Caixin Weekly*, 18 January 2016, <http://weekly.caixin.com/2016-01-15/100899749.html?pk=page2> (hereafter, Chen, "China's struggle to enter WTO"). Chen Qin is a journalist for *Caixin Weekly*.

6 Li Siji, Yao Yuan, and Tu Xinquan, "Prospects for China obtaining MES in 2016: US factors and China's strategy" (2016年中国获得“市场经济地位”的前景：美国因素与中国策略, 2016 nian zhongguo huode "shichang jingji diwei" de qianjing: meiguo yinsu yu zhongguo zhengce), *Guoji maoyi wenti*, No. 3, 2016 (hereafter, Li, Yao, and Tu, "Prospects for China"). Li Siji, Yao Yuan, and Tu Xinquan are researchers at the China-WTO research institute of Beijing's University of International Business and Economics.

7 Note that this is a point recognised by the EU as well, according to a report on the issue published by the European Parliament in November 2015. See Laura Puccio, "Granting Market Economy Status to China", European Parliamentary Research Service, November 2015, available at [http://www.europarl.europa.eu/RegData/etudes/IDAN/2015/571325/EPRS_IDA\(2015\)571325_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/IDAN/2015/571325/EPRS_IDA(2015)571325_EN.pdf).

8 Li Zhongzhou, "China's indisputable market economy status" (中国市场经济地位不容置疑, *Zhongguo shichang jingji diwei burong zhiyi*), *China WTO Tribune – Columns*, No. 2, 2016, available at <http://opinion.caixin.com/2016-02-23/100911531.html> (hereafter, Li, "China's indisputable market economy status"). Li Zhongzhou is an economist and frequent columnist for *China WTO Tribune*.

9 Chen, "China's struggle to enter WTO".

10 China still has the largest state sector of any major economy, with about 150,000 state-owned enterprises in 2013, and corresponding assets equalling 177 percent of China's GDP. See Arthur Kroeber, *China's Economy: What Everyone Needs to Know* (Oxford: Oxford University Press, 2016).

11 Li, "China's indisputable market economy status"; Bai Ming, "EU's mess surrounding China's MES is not a big deal!" (欧盟纠缠中国的市场经济地位, 真不大气!), *Oumeng jiuchan zhongguo de shichang jingji diwei, zhen bu daqi !*, *World Affairs*, No. 5, March 2016 (hereafter, Bai, "EU's mess"). Bai Ming is vice-director of the Department of International Market Research in the Ministry of Commerce's Research Institute of International Trade and Economic Cooperation.

context of weak global growth and of China's struggle to rebalance, the increasingly frequent use of anti-dumping cases against Chinese companies is worsening China's economic prospects.¹² For this reason, Bai explains, the issue of MES is crucial for China.

Clause (d) and the 15-year deadline

The issue of MES is closely linked to the upcoming expiration of Clause (a)(ii) of Article 15, as laid down under Clause (d) of the same Article, which is scheduled to take place on 11 December 2016. Much of the debate revolves around the "vagueness" (模糊, *mohu*) of Clause (d), which has led to a wide range of interpretations of its concrete implications for China.¹³

Chen, for example, cites Lu Kang, a spokesman for the Chinese Ministry of Foreign Affairs, who again said on 30 December 2015 that the use of the "surrogate country" mechanism to determine dumping will stop on 11 December 2016. But does that mean, Chen asks, that China will automatically obtain MES on 11 December 2016?¹⁴

Wu says that denying China MES would increase the "trust deficit" between the two partners.

Some observers such as Li Zhongzhou, as well as the majority of Chinese media and academic works, according to *Caixin Weekly*, argue that China's MES is "indisputable" and should be granted "automatically".¹⁵ But they recognise that a number of counter arguments have also been made, notably by lawyers from the EU and US. Moreover, officials from both the EU and the US have already rejected any automatic granting of MES.

Wu introduces an alternative interpretation, in which he refrains from openly agreeing: he says that Clause (a)(ii)'s expiry does not offer any indications for the future, and therefore leaves unlimited space for action going forward. This could mean that a new clause could be introduced, or that future rulings could be based exclusively on Clause (a)

(i), which will not expire.¹⁶ Peng Delei says that this could mean a shift in the responsibility to prove "non-market economy conditions" from Chinese companies to the investigating party. Peng recognises that this view will be hard for China to accept, but he sees it as the only way to solve the controversy around Clause (a)(ii).¹⁷

Although they do not fully agree with it, Peng, and Li, Yao and Tu, introduce another interpretation. In this reading, Clause (a)(ii) was designed as a means to protect WTO members from China's uneven economic playing field, and as a way to push China towards achieving market economy conditions by 2016. Proponents of this view argue that China's marketisation is still too low today for MES. Therefore, automatically granting MES to China would run counter both to the economic realities in China and to the very idea behind the clause. However, Xu Xin and Zhang Lei note that the spirit of the accession protocol is itself subject to debate: Chinese observers generally argue that the very fact of the existence of Clause (d) represented a tacit agreement on the eventual granting of MES. Clearing up the uncertainties about the law's original intent would only be possible if the minutes from the WTO accession negotiations were to be published and studied.

Finally, some argue that Clause (a)(ii) relates only to the use of the "surrogate country" method, and not to MES. Xu Xin and Zhang Lei say that "the two concepts are not at all equivalent".¹⁸ According to Li, Yao, and Tu, Clause (d) makes it clear that China can only be recognised as a market economy through the national laws of importing WTO members. Therefore, in 2016 "surrogate country" methods should be nullified, but MES itself can only be granted on a member-by-member basis by WTO members through their own legislation.

This widely held interpretation represents a considerable challenge for China. Granting MES in both the EU and the US will be an arbitrary and politicised process, because of the stringency of market economy criteria in the EU – Chen Qin says that only a handful of EU countries themselves actually fulfil them – and what Li, Yao, and Tu call their "vagueness" in the US.¹⁹ Besides, as Chen notes, some countries, such as Russia, did not have to fulfil these criteria before being granted MES. So any decision to hold China to EU and US criteria would be a political "double standard", motivated by trade protectionism.²⁰

However, most of the authors argue that China should not lose hope. Rather, it should realise and accept that the process of achieving MES is fundamentally a "political and trade game", and it should approach it as such, by devising

12 Wu Xiangning, "China's Market Economy Status: the EU's 'hot potato'?" (中国市场经济地位: 欧盟“烫手山芋”?), *Zhongguo shichang jingji diwei: oumeng tangshou-shanyu* (?), *Caixin Opinions*, 23 February 2016 (hereafter, Wu, "China's Market Economy Status"). Wu Xiangning is a researcher at the Institute for International Issues at Guangzhou's Sun Yat-sen University.

13 Xu Xin and Zhang Lei, "Fostering the approval process of China's Market Economy Status" (助推中国市场经济地位认可进程, *zhutui zhongguo shichang jingji diwei renke jin Cheng*), *China WTO Tribune – Special Concern*, No. 2, 2016 (hereafter, Xu and Zhang, "Fostering the approval process"). Xu and Zhang are both researchers in the Shanghai Centre for Global Trade and Economic Governance. Article 15 Clause (d) reads: "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." See WTO, WT/L/432.

14 Chen, "China's struggle to enter WTO".

15 Li, "China's indisputable market economy status", Chen, "China's struggle to enter WTO".

16 Wu, "China's Market Economy Status".

17 Peng Delei, "Non-MES after 2016 – debate, enquiry, and prospects" (2016 年后的“非市场经济地位”: 争论、探究与预判, *2016 nian hou de fei shichang jingji diwei: zhenglun, tanjiu yu yupan*), *Guoji maoyi wenti*, No. 6, 2015. Peng Delei is a researcher at the Business School of East China University of Science and Technology.

18 Xu Xin and Zhang Lei, "Fostering the approval process".

19 Chen, "China's struggle to enter WTO"; Li, Yao, and Tu, "Prospects for China".

20 Chen, "China's struggle to enter WTO".

a political strategy with regard to each WTO member so as to obtain MES in 2016.²¹

The EU's centrality to China's MES strategy

The transatlantic picture

More than 80 countries have already granted MES to China, which means that much of Beijing's attention for 2016 will be on the EU and the US, Beijing's two main trading partners, neither of which has yet recognised China's MES.²² Chinese analyses suggest that the US is reluctant to grant China MES, whereas the EU is indecisive about it.

Washington has already made clear that it will not easily grant MES to China (and that it might even deny it), because of what it sees as skewed labour and exchange rate prices, as well as pervasive intervention by the Chinese government in the economy. But beyond the economic criteria, the US position is directly influenced, according to Li, Yao, and Tu, by a mixture of political and economic elements which have politicised US-China trade and economic relations. Issues such as the US-China trade deficit and Chinese dumping have been taken up by powerful interest groups and integrated into domestic politics, putting US leaders in the uncomfortable position of having to maintain US-China cooperation while also pleasing the domestic "masses".²³ In this context, China faces the real prospect of an outright denial of MES from the US – along with a potentially unlawful refusal to drop Clause (a)(ii). In the best-case scenario, Li, Yao, and Tu say, the US will leverage MES to get concessions from China on foreign exchange policy, labour standards, and market and investment access, among other issues.²⁴

US reluctance means that most of China's efforts in 2016 will likely concentrate on gaining the EU's support. If this is to be achieved, Chen and Wu argue, understanding the ongoing debate in the EU will be key.²⁵

Deciphering the EU debate

Chen and Wu both say that the EU is deeply divided on the MES issue. Across countries and industries, there are many divergent interests. As in the US, a mixture of economic, political, technological, and legal factors are at play – all of which contribute to the uncertainty in this year's MES debate.²⁶

The main reason for the uncertainty, however, is the concern that granting MES to China could open the door to yet more cheap Chinese exports with the potential to hurt European producers. As Wu notes, the issue of dumping has become

a significant cause of tension in EU-China relations over the past few years, with the EU continuously fighting off cheap Chinese exports at the WTO level, and with European industries such as solar energy, and chemicals fiercely arguing against MES. Besides, Wu says, China's industrial upgrades have led to increasingly direct competition between Chinese and EU products.²⁷

Chen says that divisions at the EU level correspond to the competitiveness of industry within each country: countries with competitive industry sectors, such as Germany, are still indecisive, but others like Italy, Spain, and Greece are strongly opposed to MES, due to the lack of competitiveness of their domestic industries. France's position is still unclear, because of disagreement within its domestic politics. The United Kingdom, on the other hand, seems to be willing to support China without it necessarily being linked to domestic factors. At the industry level, around 25 trade associations, most of them affected by China's industrial over-capacity, have also been actively lobbying the EU to deny MES.²⁸

Chen believes that one of the deciding factors will be Germany's position on the issue. As the EU's main economic and demographic power, and its opinion leader in many respects, its decision will have the potential to rally support from many other members.²⁹

Chen and Wu identify three possible outcomes to this year's debate. The first would be that the EU rallies behind the US position, which they describe as the victory of the "US factor" in the MES debate. Wu argues that the EU has had a difficult year in terms of foreign policy, with the parallel development of an unprecedented refugee crisis and an EU-wide terrorist threat. This could lead Europe to decide to please the US in exchange for increased support. However, Wu sees this outcome as highly unlikely, because over the past few years, the EU has in its diplomacy somewhat moved away from the US rather than purely following it.

Another alternative might be the EU accepting China's MES under certain conditions. Wu says that the trade dependency that has built up between the EU and China, along with the EU's need for China as an engine of growth and recovery, might lead the EU to recognise China's achievements since 2001 by granting MES. At the same time, it could also point to areas in which its market economy criteria have not been met and use those to negotiate concessions, including

If by the end of 2016 China has not obtained any tangible results from the EU or its member states, Beijing should consider legal retaliation.

21 Xu Xin and Zhang Lei, "Fostering the approval process".

22 The other main exceptions are Canada, Japan, Mexico, and India.

23 Li, Yao, and Tu, "Prospects for China".

24 Li, Yao, and Tu, "Prospects for China".

25 Wu, "China's Market Economy Status"; Chen, "China's struggle to enter WTO".

26 Wu, "China's Market Economy Status"; Chen, "China's struggle to enter WTO".

27 Wu, "China's Market Economy Status".

28 Chen, "China's struggle to enter WTO".

29 Chen points out here the importance of demography, because the vote to grant MES will have to reach qualified majority at the European Council, which requires adoption by countries representing at least 65 percent of the EU's population. He also notes that Germany has very rarely been in the minority in the major decisions that have been passed to date at the European Council level (Chen, "China's struggle to enter WTO").

promises on market access, Intellectual Property Protection, subsidy reduction, and exchange rate policy. Both Chen and Wu consider this to be the most likely outcome.

However, the two writers also consider the possibility of a third outcome, which would be a replay of last year's Asian Infrastructure Investment Bank accession process. In this scenario, Europeans would disregard US guidance and unilaterally declare themselves in favour of MES, without setting any preconditions.³⁰ Although it is quite unlikely that this would happen, Bai suggests that this would be the best outcome for China.³¹

Multi-pronged strategies for China's MES

The ultimate decision on China's MES status lies with EU member states, but some of the authors argue that Beijing should not sit quietly and wait for them to make a choice. Instead, the Chinese government should actively adopt political, legal, and economic strategies to win support.

Xu and Zhang think that the key is to convince the EU that granting China MES is in its own best interest, and that it will not benefit from continued protectionism after 2016.³² For one thing, without the tools provided by Article 15, the EU will win fewer anti-dumping lawsuits. So, resisting MES would put Europe in the uncomfortable position of having to abide by WTO rules while attempting to continue taking discriminatory measures against China. Instead of this, the EU should accept MES, and encourage its consumers and importers to reap whatever profits they can from increased trade with China. Wu and Li's arguments are quite similar, but worded in a much more threatening way. Wu says that denying China MES would deeply hurt China-EU relations and increase the "trust deficit" between the two partners. Li says that by rejecting MES, the EU would "bring trouble onto itself".³³

In their view, to make sure this is understood and to win EU support, China must engage in active lobbying. Chinese industry associations must launch a lobbying campaign with the EU, and particularly with the EU Chamber of Commerce in China.³⁴ And Beijing should make MES the "hot spot" of its diplomacy. In this context, Wu thinks that China has some flexibility because of the two available levels of decision-making: the EU level and member state level. In trying to influence member states, Beijing can rely on the good relations it has developed bilaterally with, for example, the UK, Germany, and France. At the EU level, China can use its ongoing negotiations – and especially those on a Bilateral Investment Treaty – to push for MES. Finally, Li, Tao, and Yu say that China can and should be open to negotiation and offering concessions in return for MES –

including controlled but increased economic opening.

However, if by the end of 2016 China has not obtained any tangible results from the EU or its member states, Beijing should consider legal retaliation. Li, Yao, and Tu, as well as Li Zhongzhou, suggest that China should make it clear that if any WTO members refuse to abide by Article 15, it will use all available treaties and legal means to guarantee its rights. China will not hesitate, either, to bring up the issue at the WTO Ministerial Conference, and to ask for clarification on the issue. That would not be the optimal choice for China, because it would involve a bitter and lengthy battle, but it should be kept open as an option that is at Beijing's disposal.³⁵

The strategies discussed are all outward-looking, but several authors also spell out a set of domestic measures – including more pro-market business rules, clarifying links between businesses and the government, and diminishing government support for the business sector – which chime oddly with the issue at stake. Indeed, it is telling that most if not all the authors cited here argue for MES recognition, while at the same time recognising the pressing need for further reform and marketisation in China. Although this is not illogical, it underlines the fact that the debate on both sides has little to do with actual market economy conditions – all the authors recognise that China has a long way to go – but much more to do with politics and diplomacy. Whatever China says about the automatic granting of MES, there is a clear awareness that the country is facing a lengthy and complex political process. This is why all the authors call for complete mobilisation around this issue, at all levels of China's relations with member states and the EU.

³⁰ Wu, "China's Market Economy Status"; Chen, "China's struggle to enter WTO".

³¹ Bai, "EU's mess".

³² Xu and Zhang, "Fostering the approval process".

³³ Wu, "China's Market Economy Status"; Li, "China's indisputable market economy status".

³⁴ Xu and Zhang, "Fostering the approval process".

³⁵ Li, Yao, and Tu, "Prospects for China"; Li, "China's indisputable market economy status".

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