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# CHINA'S MARKET ECONOMY STATUS AND THE EUROPEAN INTEREST

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## SUMMARY

- The question of market economy status for China has only symbolic importance. What is really at stake is the special rules that Europe applies against the “dumping” of cheap Chinese exports – which expire in December 2016.
- Europe is caught between the job losses that would result if it dropped the current trade protections, allowing China to flood the international markets with rock-bottom exports, and the wish of many to win Chinese investment. For its part, Beijing has not engaged fully in high-level dialogue on the issue.
- Keeping the current anti-dumping measures in place would only be a short-term option, as China will launch a legal challenge once the deadline runs out. However, Europe should not dismantle existing protections for its producers before it has put in place an effective alternative.
- The only clean way out is an overall reform of Europe's trade defence instruments, to protect producers without discriminating against China. This will take time, and Europe should try to reach an understanding with China in the meantime to avoid a legal dispute or trade war.
- At stake is Europe's reputation for upholding international law, and defending the employment and well-being of its people.

By 11 December 2016, the European Union has to decide whether China should officially join the club as a market economy, able to trade freely without special tariffs – or does it?

China joined the World Trade Organization (WTO) in 2001 under a 15-year transition period. This gives other WTO members greater scope to impose tariffs against “dumping” – when its exports are priced unfairly low. China pledged to make major economic reforms in this time, and campaigned hard for several years to win recognition as a market economy. But now, as the end of the transition period looms, China is focusing on the narrower goal of ending the special anti-dumping provisions. This would result in China being treated de facto as a market economy, regardless of whether WTO members formally grant it market economy status (MES).

MES is a mere status symbol. It is not defined by the WTO, although some WTO members have their own definitions. Indeed, the EU granted Russia this recognition in 2002, and Russia is hardly a market economy. China under President Xi Jinping is even less of a market economy, although it is thriving and dynamic.

What is really in question is how the EU should deal with the asymmetry between Europe, the world's biggest market, and China, the world's biggest industrial producer. Backed by massive state capital, Chinese firms can buy top European firms such as Volvo, Pirelli, or Syngenta, but European firms cannot do the same in China. European regulators punish member states who illegitimately subsidise their businesses, but in China, the price of the land a company builds on, the energy it uses, and the financing it gets are all set by the state.

When China's state investment policies go too far, as is currently the case with steel, aluminium, and ceramics – and in the past with solar panels – the very notion of the price for inputs disappears. China's products flood the international markets, priced below the cost of production. And this isn't a passing policy but a product of an economic culture that could outlast even major reforms to the state-run economy. For decades to come, China's leaders will still be under great pressure to keep finding jobs for millions entering the workforce or leaving the farms.

The asymmetry threatens Europe's very fabric. Beijing's economic policies are deeply divisive. China provides inexpensive goods for consumers, but takes jobs away from producers. It accepts foreign investment, but creates copy-cat companies and products, bending international rules to support its own producers. Increasingly, China invests in Europe, which is both a benefit and a curse, since it provides much-needed funds but also acquires control and leverage over European companies and societies.

It is hugely important for Europe to find a trade regime that is suitable for China. China is the Union's second-biggest trade partner and is a key link in the global production chain, without which the shelves of our shops would be half empty. The EU's defining talent is its ability to set a mix of rules that balance free trade and the welfare state. Sitting passively while this balance is under threat, because China has grown more than it has changed, is not an option. Inaction would only feed a massive popular backlash against global free trade.

Fortunately, there are signs that France and Germany are jointly moving to take action on MES within the European Council. The European Parliament has taken a clear stand on the issue, stating that WTO members will still be able to apply "special rules" to Chinese imports once the deadline is up. Meanwhile, the European Commission seems to be considering legislation to give European markets some recourse against excessively low prices, without discriminating against China.

The term "market economy status" hides the real issues in play. For Europe, these are the imperatives to set an example by upholding international law, and to promote the European interest. At stake is Europe's capacity for global influence as the world's largest trading bloc, and its ability to promote the well-being of its citizens. Failing to effectively address the China MES issue could break the foundational pillar of the European edifice – its common market and trade policy.

This paper starts by investigating what MES actually means, setting out the issues at stake for Europe and for China with the impending December deadline. It argues that MES is a red herring, and that what is really important to China – and Europe – are anti-dumping duties. Its second section weighs the positive and negative economic impacts that granting MES to China would have on Europe – across employment, prices, and the manufacturing and services industries – and sets out the divides between, and within, Europe's capitals on the issue.

The third section examines the twin political processes that are underway in the EU over MES, and how the European Parliament has stepped up to become a tough new actor on the issue. Finally, the paper sets out Europe's options, and makes a series of recommendations for how Europe can uphold international law and the principles of free trade while protecting the livelihoods of its people. It calls for Europe to commit to granting MES to China, as denying it creates an unnecessary conflict over something of merely symbolic value, but to leave its anti-dumping laws unchanged until new trade defence instruments can be put in place.

## What is market economy status?

Search the text of China's WTO accession protocol,<sup>1</sup> and you will find only three mentions of the term "market economy", none of "status", and one of "non-market economy" (NME). The term is not defined, and its criteria differ from one WTO member to another.

However, the protocol does set out the criteria for identifying Chinese dumping for a "transition period" of 15 years after WTO accession. This ends on 11 December 2016. Once the deadline has passed, other countries can no longer use the "surrogate country" method to impose anti-dumping duties on China. This allows importing countries to determine whether export prices are unfairly low by comparing them with domestic prices in a third country – bypassing the problem that the exporter's domestic prices may themselves be artificially held down.

But the protocol is ambiguous – it does not clearly ban WTO members from applying other special anti-dumping criteria that they do not use for market economies. Still less does it make clear that they must grant MES to China once the transition period is over. The text leaves the question of whether China – or any other country – is treated as a market economy to the national legislation of WTO states. However, countries that did not have a legislative process in place for determining MES at the time the protocol was signed in 2001 will be vulnerable to legal action by China after the deadline.

Many countries are *not* committed to granting MES after the deadline. Some require no legislative action to declare or rescind MES, and their anti-dumping criteria are set by simple executive action. This means that there is no legislation for China to challenge via the WTO, and it will have to wait for the first anti-dumping case after the deadline.

For example, the US administration can decide on the issue at its discretion and has set its own legal criteria for MES – presidential hopeful Hillary Clinton has said: "I'll oppose efforts to grant China so-called 'market economy' status".<sup>2</sup> India has adopted legal criteria, but retains a free hand in deciding the outcome, outside any legislative process. Canada, which

<sup>1</sup> "Protocols of accession for new members since 1995, including commitments in goods and services", World Trade Organization, 30 November 2015, available at [https://www.wto.org/english/thewto\\_e/acc\\_e/completeacc\\_e.htm](https://www.wto.org/english/thewto_e/acc_e/completeacc_e.htm).

<sup>2</sup> Joseph S. Pete, "Clinton vows to take on steel dumping, Chinese overcapacity", the *Northwest Indiana Times*, 11 April 2016, available at [http://www.nwtimes.com/business/steel/clinton-vows-to-take-on-steel-dumping-chinese-overcapacity/article\\_d766779e-4717-514f-92d2-3edfe8e1ed71.html](http://www.nwtimes.com/business/steel/clinton-vows-to-take-on-steel-dumping-chinese-overcapacity/article_d766779e-4717-514f-92d2-3edfe8e1ed71.html).

originally took a very open attitude in placing the burden of proof for non-market conditions on Canadian firms and not on China, briefly passed legislation in 2002 recognising the 2016 deadline for granting MES to China, but rescinded it in 2013. Japan also recognised a 2016 deadline, but this is only a government guideline, not a legislative act.

By contrast, the EU's anti-dumping rules are governed by legislation. Since 1998, it has introduced several amendments to its anti-dumping regulations that set out specific methodologies for identifying dumping by China, Russia, and a list of other non-market economies. Changing these rules, or the list, requires legislation by the European Council<sup>3</sup> and the Parliament.

With its usual enthusiasm for the legal order, Europe created a problem for itself that most other WTO members do not have. If it takes no action to change its legislation by 11 December, China could challenge this through the WTO's Appellate Body. Europe has placed itself out in front, in a "damned if you do, damned if you don't" position.

### *A red herring?*

The fact is that market economy status itself is irrelevant – it has no legal meaning. What is really at stake are the anti-dumping rules imposed on China. Indeed, EU trade authorities usually start discussions on this issue by stating that "of course" China is not a market economy.<sup>4</sup> They then discuss why Europe should – or should not – treat it as one when it comes to dumping.

Whether to grant market economy status is therefore a political decision, with a big media impact. Given China's insistence on status, it may well lobby and even fight diplomatic battles to win this recognition, but its real concern is the methodology that will be used to identify dumping.

Recognising China as a market economy does not necessarily mean that countries will treat it like any other WTO member in terms of dumping. Countries that have declared China to be a market economy have generally toughened their anti-dumping rules at the same time, indicating that, while they may be willing to give it the symbolic status, they will keep protecting their industries from cheap Chinese exports. Likewise, though the EU granted Russia MES in 2002, a full decade before the country joined the WTO, the EU added special measures to its anti-dumping regulations to protect against dumping by Russia.

As a result, China has not made much effort to convince the EU that it is a market economy.<sup>5</sup> This may be because it is focusing on getting the key anti-dumping provisions dropped once the transition period ends on 11 December, rather than

3 Currently, 16 countries including 65 percent of the EU's population.

4 Jean-Luc Demarty, "Personne ne pense que la chine est une economie de marche", *Les Echos*, 6 April 2016 available at <http://www.lesechos.fr/monde/europe/021822025076-jean-luc-demarty-personne-ne-pense-que-la-chine-est-une-economie-de-marche-1212045.php>.

5 For more details on Chinese views and strategies regarding the recognition of Market Economy status, see the Special issue of China Analysis: "Time's up: China coming battle for Market Economy Status", European Council on Foreign Relations, June 2016, available at <http://ecfr.eu>.

re-opening a debate on the nature of its economy. Since 2004 – when the EU found that China had fulfilled just one criteria out of five to qualify as a market economy – China has submitted little evidence to bolster its case, and none since 2008.<sup>6</sup> It has only intermittently agreed to hold the EU–China High Level Economic and Trade Dialogue (HED), inaugurated in 2008: no meeting took place in 2011, 2012, or 2014.

China has made its position clear – what matters are the anti-dumping rules, not market economy status. Foreign Ministry spokesperson Hua Chunying has said: "There is no such concept as 'market economy status' in the WTO rules."<sup>7</sup> In February 2016, the Chinese envoy to the EU made clear that the change to anti-dumping rules was distinct from – and possibly more important than – the question of MES. "The real issue is about the EU honouring an international legal obligation, namely Article 15 of the Protocol on the Accession of China to the WTO which requires its Members to stop using analogue country method in anti-dumping investigations against China as of December 11, 2016. Though this and MES are related, they are different issues. Whether or not China's market economy status is recognized, WTO Members are under the obligation to apply the rules of the WTO."<sup>8</sup>

In the US, China is so little concerned by market economy status that several of its state-owned enterprises have recently challenged commercial cases against them by claiming sovereign immunity. China's Foreign Ministry has also protested against legal actions against "state-owned properties".<sup>9</sup>

Old-timers in Brussels date this change back to the handover of the Chinese leadership in 2012. They note that former leaders Hu Jintao and Wen Jiabao had insisted on market economy status – and took measures to secure it, such as ending VAT rebates to counter an excessive rise in exports. By contrast, Xi Jinping has never raised the issue, and Prime Minister Li Keqiang "has only done so indirectly", according to one EU official.<sup>10</sup>

There are three options: either China remains in the category of non-market economies, or it joins a group that consists at present of only one country – Russia – which is deemed a market economy but subject to special anti-dumping measures, or it gains full acceptance as a market economy. In the latter case, the debate will likely turn, in Europe and elsewhere, to strengthening trade defence instruments overall. As well as anti-dumping measures, these include steps to guard against other "unfair" practices, such as government subsidies to exporters.

6 See Commission staff working document, 19 September 2008, for progress up to 2008, available at [http://trade.ec.europa.eu/doclib/docs/2009/june/tradoc\\_143599.pdf](http://trade.ec.europa.eu/doclib/docs/2009/june/tradoc_143599.pdf).

7 Foreign Ministry Spokesperson Hua Chunying's Regular Press Conference on 27 May 2016, available at [http://www.fmprc.gov.cn/mfa\\_eng/xwfw\\_665399/s2510\\_665401/t1367062.shtml](http://www.fmprc.gov.cn/mfa_eng/xwfw_665399/s2510_665401/t1367062.shtml).

8 Keynote Speech by H.E. Ambassador Yang Yanyi, Head of the Chinese Mission to the EU, at BUSINESSEUROPE Executive Committee Meeting, 25 February 2016, available at <http://www.chinamission.be/eng/mh/t1343489.htm>.

9 Matthew Miller and Michael Martina, "Chinese state entities argue they have 'sovereign immunity' in U.S. courts", *Reuters*, 11 May 2016, available at [http://www.reuters.com/article/us-china-usa-companies-lawsuits-idUSKCN0Y2131?feedType=nl&feedName=domesticNews&utm\\_source=Salithru&utm\\_medium=email&utm\\_campaign=USPercent20Toppercent20Newspercent202016-05-11&utm\\_term=USPercent20Toppercent25](http://www.reuters.com/article/us-china-usa-companies-lawsuits-idUSKCN0Y2131?feedType=nl&feedName=domesticNews&utm_source=Salithru&utm_medium=email&utm_campaign=USPercent20Toppercent20Newspercent202016-05-11&utm_term=USPercent20Toppercent25).

10 Interview with EU official, Brussels, 23 May 2016.

## The economic impact of MES

Much has already been written on the impact of granting MES to China – or denying it. This falls into several broad categories.

### *Job losses vs low prices*

One important question is whether cheap Chinese exports hurt other countries by causing job losses, or help them by keeping prices low.

Estimates vary about the effect on jobs. An impact report was delivered to the Commission in May 2016, and its preliminary findings were released in February.<sup>11</sup> These put potential job losses between 64,000 and 211,000. Reportedly, the full report is even more pessimistic, particularly on potential job losses in Europe.

However, they do not come anywhere near the dark estimates made in a private report commissioned by US think-tank the Economic Policy Institute (EPI) and sponsored by European manufacturers association Aegis.<sup>12</sup> This estimates between 1.7 and 3.5 million job losses in three to five years – and even more when indirect job losses are counted.

Part of the variation is easy to explain. The Commission's report only studies the effects on the 52 sectors where anti-dumping measures concerning China were in place at the end of 2015, whereas the EPI study is based on the projected growth of Chinese exports to Europe, including numerous other sectors, and the presumption of systematic dumping on the part of China. In comparison, a recent study by another US think-tank found that imports from China resulted in the loss of 2.4 million manufacturing jobs in the US between 1999 and 2011.<sup>13</sup>

In addition to their direct impact in challenging proven cases of dumping, these measures deter producers from launching other aggressive dumping strategies. Remove this threat, and you may get many more instances of unchallengeable dumping. As of December 2015, the EU's 52 anti-dumping measures covered only 0.68 percent of Chinese exports to Europe. But this makes up half of all EU anti-dumping cases, and 80 percent of the overall quantities of goods by value. And the Commission's preliminary report cites the statistic that, on average, anti-dumping sanctions have historically been imposed against 2.5 percent of China's total exports to Europe.

<sup>11</sup> "Change in the methodology for anti-dumping investigations concerning China", 5 February 2016, available at <http://www.trade.ec.europa.eu/doclib/html/154241.htm> (hereafter, "Change in the methodology for anti-dumping investigations concerning China").

<sup>12</sup> Robert E. Scott and Xiao Jiang, "Unilateral Grant of Market Economy Status to China Would Put Millions of EU Jobs at Risk", Economic Policy Institute, 18 September 2015, available at <http://static1.squarespace.com/static/5537b2fbc40e49a1e30c01c/t/55f0373e4b09a69209aa9c2/1443621109236/Unilateral+grant+of+Market+Economy+Status+to+China+would+put+millions+of+EU+jobs+at+risk.pdf>.

<sup>13</sup> David H. Autor, David Dorn, and Gordon H. Hanson, "The China Shock: Learning from Labor Market Adjustment to Large Changes in Trade", National Board of Economic Research (NBER), working paper n° 21906, January 2016, p. 31, available at <http://www.nber.org/papers/w21906>.

There is another perspective, of course. China is also a huge market for foreign firms, and while it is the world's biggest exporter, foreign firms benefit from these exports. China's low prices can be a good thing for other economies. Its industrial production alone is now 50 percent higher than that of the US. China generates low prices as an assembly plant for the world's consumer goods – that make up two-thirds of its exports – which benefits final users elsewhere. This argument was made for its export of solar panels, and can be made again for aluminium. Through artificially low energy input prices, China has captured 55 percent of the world's aluminium market, but its deflationary impact on the aluminium price allows car manufacturers, for example, to increase their use of the material and achieve energy efficiency targets.

### *Manufacturing vs services*

Others make the case that China's low-cost exports have a declining importance in the global economy, and therefore that tough anti-dumping measures are not essential. China represents the manufacturing age. The future belongs to service industries and the virtual economy, and more subtle trade barriers – especially the creative use of norms and standards – matter more than old-fashioned custom fees on physical goods.

The end of the manufacturing age might coincide with huge levels of unemployment, and China is not immune. Foxconn, the Taiwanese manufacturer for most iPhones, has just done away with 60,000 industry jobs in a single Chinese factory by replacing them with robots.<sup>14</sup>

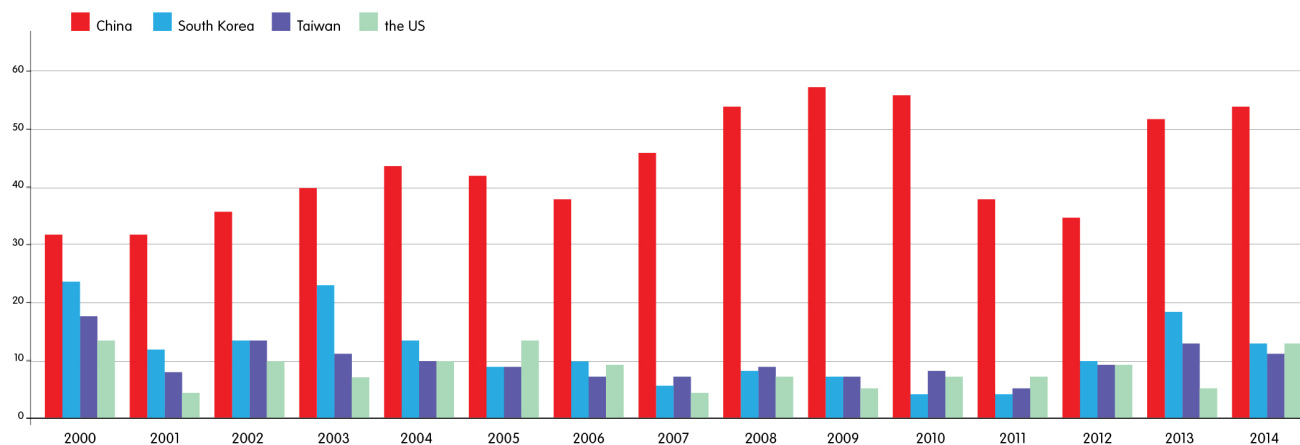
Still, at present, China symbolises the manufacturing age, and its economic strength is almost entirely based on industry and producing physical goods. Even its financial clout largely originates with the high external trade imbalance and low domestic wages that allow for big profits. The low cost of manufacturing is a key ingredient in China's international advantage, as the price of many inputs, starting from land use, is largely set by the state. China's lead would be much less clear if labour productivity, energy efficiency, and technological innovation were deciding factors, or if the state did not grant land for industrial use at bargain prices.

The odds are increasingly stacked against a successful Chinese transition to a knowledge rather than resource-based economy. A slowdown or halt in economic reforms, increasingly curtailed access to the internet, and heavy controls on information and education are raising the barriers to China becoming a genuine source of innovation. A huge chunk of China's economy will remain committed to industrial production – and therefore to the export of goods, with the attendant issue of dumping.

China has probably hurt its case for MES by dragging its feet in negotiations for an agreement on opening public procurement to international competition. Under the Italian presidency in 2014, the EU set a requirement for reciprocity on this matter, and Italian officials are fond of citing the fact that

<sup>14</sup> Mandy Zuo, "Rise of the robots: 60,000 workers culled from just one factory as China's struggling electronics hub turns to artificial intelligence", *South China Morning Post*, 21 May 2016, available at <http://www.scmp.com/news/china/economy/article/1949918/rise-robots-60000-workers-culled-just-one-factory-chinas>.

## Anti-dumping measures per year: The four most targeted exporters



Source: World Trade Organization

while 80 percent of the EU's public procurement is open to international competition, China's figure is only 14 percent.<sup>15</sup>

### *China as investor*

A more mundane case for granting MES is made by those who see dumping as a secondary issue, far less significant than Chinese investment in Europe. China is fast becoming an important investor in the continent – at €20.5 billion, the figure for 2015 has surpassed European investment in China, and is continuing to boom in 2016. China's financial investments, as well as real-estate purchases by Chinese individuals or companies, are probably greatly underestimated. Different criteria for declaring the purchase of company stock (for example, the threshold is 1 percent in Italy and 5 percent in France), the use of trust companies and offshore accounts, and a stampede for the exit by China's moneyed class in the past two years contribute to this.

Many EU countries, trapped only a few years ago by the euro crisis, are now competing for low cost cash from investment funds. The so-called Juncker fund itself, the European Fund for Strategic Investment (EFSI),<sup>16</sup> depends on the good will of large investors – including China. “How does Juncker receiving steel workers balance Juncker creating the Juncker fund?”, one participant in the process noted drily.<sup>17</sup> Indeed, it is very rare for a Commission president to receive demonstrators passing in the street below.

### *Views across Europe*

How do the arguments about job losses vs. investment gains play across Europe, and across different sectors? It is impossible to chart comprehensively, but some contrasts do emerge. The EIP–Aegis study foresees the highest job losses relative to the size of the economy in the six main Eastern European member states, while the four largest Western European economies top the list in absolute terms. Germany, Poland,

<sup>15</sup> Interviews with Italian officials, April–May 2016.

<sup>16</sup> “Change in the methodology for anti-dumping investigations concerning China”, pp. 7–8.

<sup>17</sup> Interview with EU official, Brussels, 26 April 2016.

Italy, and Bulgaria stand particularly high on one criterion or another. The Commission's preliminary findings point to the biggest losses in Germany, Italy, and Spain, followed by France, Poland, and Portugal. Strikingly, no northern European member state appears anywhere near the top of the list in either report – Sweden is number 16 in the EIP–Aegis study<sup>18</sup> and number 10 in the Commission's report.

The textile, IT, and furniture sectors appear set to be the hardest hit in the EIP–Aegis report, while in the Commission's report – which only looks at sectors currently under anti-dumping measures – ceramics tops the list with 47 percent of all projected job losses, followed by textiles and “others” at 13 percent.

And what about support for Chinese investment? We can only sketch a broad picture of how this breaks down across Europe. The UK, its Treasury, and the City of London are the most obvious advocates, along with the Netherlands, given that Rotterdam is the main transit point for Chinese exports to Europe. Yet the pace of Chinese investment in the UK slowed in 2015 – after 15 years of it being the top European destination. Meanwhile, the research for this report identified enthusiastic support for Chinese investment – and fear of the consequences of denying it MES – in several southern European economies.

This was the case in Italy, despite the fact that the government has taken a strong negative stance on the issue so far. Italy was the top European destination for Chinese investment in 2015, with the acquisition of Pirelli. While the official position is against MES, businessmen and economists voice different opinions. Among their arguments: “Why should Italy stay locked into low-tech industries, and should the world's eighth-biggest industrial power keep producing 200 million pairs of shoes per year?”, and “We should not be on the losing side.”<sup>19</sup>

In Portugal, China has pitched an industrial park and a rail-

<sup>18</sup> EIP–Aegis, op. cit., Table 6, p. 22, available at <http://static.squarespace.com/static/5537b2f4e40e49a1e30c01c/1/55fc0373e4b09a69209aa9c2/1443621109236/Unilateral+grant+of+Market+Economy+Status+to+China+would+put+millions+of+EU+job+s+at+risk.pdf>.

<sup>19</sup> Participants at roundtable at Istituto Affari Internazionali (IAI), Rome, 15 April 2016.

way linked to Sines, a new container port that is the closest European point to the Panama Canal: here, on the edge of Western Europe, we find the same wish for Chinese investment as in Greece.<sup>20</sup> France is acquiring more Chinese investment, ranking second in Europe in 2015. This is focused on tourism and real estate, and so lacks major strategic implications. However, the sale of airports, including Toulouse to a Chinese group, raised public concerns, and the projected acquisition of Accor, the leading hotel group, is facing objections from President François Hollande. There are contrasts within Eastern Europe: while Bulgaria and Hungary avoid taking public stands on the issue within EU institutions, Poland has opposed granting MES for China.

A key deciding factor will be Germany, which in principle favours MES for China, but in practice is undecided. Germany's GDP matches that of the 20 smallest EU member states combined, and its trade with China is 50 percent of the EU's total trade with the country. But there are major divisions between German firms, matching those between European member states. The government is being lobbied hard in both directions.<sup>21</sup> The ceramics and cement industries are in the "no" camp. Auto parts suppliers may be too – but not the main manufacturers, who benefit from low prices and a huge Chinese market. German textile firms, which deal mostly with high-tech material, are not opposed to MES. While firms' representatives in China are aware of the risk posed by MES, their board members often look at the broader investment picture instead. So do family firms, who often have a potential Chinese buyer in their sights.<sup>22</sup> For example, in the last three years Chinese home appliance company Midea has moved to acquire a controlling stake in KUKA, a partly family-owned company that is the principal manufacturer of robots for the German auto industry. The move is welcomed by the board but has raised eyebrows elsewhere, as this is a strategic component of German car manufacturing.<sup>23</sup>

A large sector of German industry would rather leave the MES issue to Brussels, probably so as not to get burned with China. Some suggest *à la carte* MES,<sup>24</sup> under which Chinese industry sectors that can prove they follow market rules would be treated as standard, while others would get a different treatment. Though appealing, the compromise is unlikely to be accepted by China.

### At EU level

At an informal Council meeting of trade ministers in Amsterdam in February, Trade Commissioner Cecilia Malmström reportedly explained that the EU would be forced to concede the end of the transition period and grant MES after the December deadline. She emphasised the need for mitigation measures to protect the industries that would be worst hit. Several large member states reportedly did

not express an opinion, with Italy and perhaps Poland the only countries opposing MES. Denmark, Sweden, Finland, Estonia, and Latvia were positive. The UK, absorbed by the Brexit issue, is also said to have remained silent.<sup>25</sup> One Council source estimates that as many as 14 member states may have expressed some support for MES at this meeting.

It is widely rumoured that the initial instinct of EU DG Trade officials to treat the granting of MES as a matter of course was tempered by two of the three EU presidents – namely Jean-Claude Juncker and Donald Tusk – and finally by the trade commissioner herself, a no-nonsense trade liberal. They grasped that in a Europe wracked with complaints about globalisation and the lack of adequate protection from Brussels, granting MES to a huge economy that clearly is not a market economy could have serious political consequences. Juncker understood that the issue was "hell on wheels",<sup>26</sup> and he received demonstrating steel workers in February to show his concern about the issue.

It is probably no coincidence that these two presidents are from countries that stand to take a big hit if China is granted MES. Tusk is from Poland – a member state which stands to see some of the highest job losses from MES; while Juncker is from Luxembourg, where the financial industry is important but steel also has a long tradition. High Representative Federica Mogherini, meanwhile, is said to have been initially more sensitive to broad geopolitical arguments in favour of conceding MES.

EU Vice President Jyrki Katainen, a Finnish trade liberal, has made two trips to Beijing in the last six months. He was, according to some, attempting to obtain "a credible and verifiable reduction in capacity"<sup>27</sup> of steel from China. The results, including on his second visit in April 2016, have been underwhelming: "He came back with 45 minutes of stonewalling and fine words on overcapacities."<sup>28</sup> French and German officials have also indicated that China is essentially turning down any request for change, and standing firm on its argument that the EU is legally obliged to grant MES.

## The political process

As with many crises, the Union has moved late on the question of MES – a fact that is noted by the latest EU Parliament resolution on the topic. Discussions between EU officials and the Chinese government have tended to focus on China's initiatives, such as One Belt, One Road (OBOR) and Chinese access to the European market, rather than on opening China's market to European investment. One European official in Beijing noted that it is already far too late for Europe to obtain concessions on market access in China before the December deadline, especially if this implies structural reforms on the part of Beijing.<sup>29</sup>

<sup>20</sup> Interview in Lisbon, 17 May 2016.

<sup>21</sup> Interview in Berlin, 11 February 2016.

<sup>22</sup> Interview in Berlin, 5 April 2016.

<sup>23</sup> "Politik fürchtet Kuka-Verkauf nach China", *Spiegel Online*, 30 May 2016, available at <http://www.spiegel.de/wirtschaft/unternehmen/kuka-grossaktionar-bremst-vorstand-bei-midea-angebot-a-1094935.html>.

<sup>24</sup> Interview in Berlin, 5 April 2016.

<sup>25</sup> Interview in Brussels, 27 April 2016.

<sup>26</sup> In the words of an EU official, interview, 23 May 2016.

<sup>27</sup> Interview in Brussels, 27 April 2016.

<sup>28</sup> Interview with EU official, Brussels, 23 May 2016.

<sup>29</sup> Meeting with European official, Beijing, 21 March 2016.

As late as November 2015, Commissioner Malmström and Trade Director General Jean-Luc de Marty were ready to concede MES,<sup>30</sup> and were trying to coordinate the move with the US. So were most of the member states. France is said to have assured China in November 2015 – shortly before the COP 21 climate conference in Paris – that it would approve the change of status.<sup>31</sup> Chancellor Angela Merkel said during a visit to China in October 2015 that “the German government supports the wish of the Chinese side to obtain EU MES”, although that statement was balanced by a requirement for China to move ahead on opening public procurement.<sup>32</sup>

“Steel changed their minds”, as one industry representative in Brussels put it.<sup>33</sup> China’s enormous overcapacity in steel production has captured the attention of both the public and officials across Europe. Its cheap exports have depressed world prices and spread China’s overcapacity crisis to its competitors. Although China maintains that its exports only make up 11 percent of global trade in steel, and that only 14 percent of EU steel imports are from China, the rise in volume has been enormous.

The fact that this rise took place in the two years preceding the decision on MES shows that China either drastically underestimated the problem or did not make it a priority. In the words of one EU official: “China has turned this into an electoral issue across Europe, and will now pay the price for it.”<sup>34</sup>

The US, which had hedged its position on MES, came out into the open in late 2015, publicly asking the EU not to grant MES. It is hard to know the reasons for taking such a visible stand. On the one hand, the presidential campaign was starting to heat up. The US’s experience with the new China-led Asian Infrastructure Investment Bank (AIIB), where Washington’s failure to speak out resulted in Europeans breaking ranks to join China’s project, may have played a role. Indeed, the Commission may have believed that the US Department of Commerce was preparing to grant MES.<sup>35</sup>

### *A tougher response from Europe*

There are now two high-level EU processes under way to decide the MES question. One is the follow-up to a public consultation completed by the Commission in April 2016.<sup>36</sup> The other is in the European Parliament, whose International Trade Committee (INTA) is conducting a series of hearings.

After misjudging the potential public opinion fallout, perhaps overestimating China’s readiness to talk, and dealing with the issue in autopilot mode, the Commission changed tack in the first quarter of 2016. It is now carrying out a thor-

<sup>30</sup> Interview in Brussels, 23 May 2016.

<sup>31</sup> Interview with a business representative in Beijing, 21 March 2016.

<sup>32</sup> “China is an important player in the world, says Chancellor”, German Federal Government, 30 October 2015, available at [https://www.bundesregierung.de/Content/EN/Reiseberichte/2015/2015-10-29-merkel-china\\_en.html](https://www.bundesregierung.de/Content/EN/Reiseberichte/2015/2015-10-29-merkel-china_en.html).

<sup>33</sup> Interview in Brussels, 23 May 2016.

<sup>34</sup> Interview in Brussels, 23 May 2016.

<sup>35</sup> Interview in Brussels, 23 May 2016.

<sup>36</sup> Its terms are available at [http://trade.ec.europa.eu/consultations/index.cfm?consultation\\_id=191](http://trade.ec.europa.eu/consultations/index.cfm?consultation_id=191).

ough and relatively transparent process before it makes a decision on MES.

The Commission also paid attention when the US imposed stiff anti-dumping penalties (415 percent) on Chinese steel exporters on 1 March. This raised the dire possibility that the EU could become the market of last resort for Chinese steel exports. Later that month, a Commission report on steel stated the intention to impose mitigating measures, while preserving strong anti-dumping provisions, and introducing new trade defence instruments.<sup>37</sup>

The attitude of two key member states has also changed. At the Council’s informal meeting of ministers responsible for trade on 3 May, France and Germany reportedly submitted an informal paper outlining a joint proposal to modernise trade instruments.<sup>38</sup> It recommends continuing to take special measures to identify Chinese dumping, placing the burden of proof on Chinese manufacturers.

Among its many recommendations, the paper calls for a speedier process and more discretion for the Commission to act on this issue. This includes the power to increase the penalties from the current “lesser duty rule” – an EU rule which specifies that anti-dumping penalties should be only enough to remove the advantage of dumped goods, rather than being set punitively high. It would also include greater attention, modelled on trade with Russia, to the prices of energy and raw materials. More broadly, it asserts the “EU interest” over the interests of member states and calls for compromise between member states.

Taken together, these proposals also suggest that there could be a clash with the United Kingdom. The move by France and Germany had been foreshadowed by the decision of German Economy Minister Sigmar Gabriel to co-sign a letter with six other European economy ministers calling on the Commission to be firm on the issue of China’s overcapacity in steel. As a source within the German government commented: “It is rare for a German minister to sign an appeal for anti-dumping measures with his Belgian and French colleagues.”<sup>39</sup> Just as strikingly, Emmanuel Macron, the French Minister of the Economy, is generally placed in the liberal camp on trade matters and has on occasion argued for Chinese investment. The UK, for its part, reportedly blocked a reform of trade defence instruments at the Foreign Affairs Council in March. This is in spite of the crisis in Tata’s steel manufacturing in Port Talbot, Wales, which has been aggravated by Chinese steel exports to Europe. Additionally, China, in a daring move, has slapped anti-dumping duties on exactly the category of steel products that originate in Port Talbot.<sup>40</sup>

<sup>37</sup> “Steel: Preserving sustainable jobs and growth in Europe”, European Commission, 16 March 2016, available at <http://ec.europa.eu/DocsRoom/documents/15947>.

<sup>38</sup> “Draft, (03/05/2016) Common core demands from Germany and France on modernising the Trade Defence Instruments (TDI) of the European Union (EU)”, obtained from non-official source.

<sup>39</sup> Interview in Berlin, 6 April 2016.

<sup>40</sup> “China to levy duties on imports of acrylic fibers, steel”, *Xinhua*, 1 April 2016, available at [http://www.china.org.cn/business/2016-04/01/content\\_38160460.htm](http://www.china.org.cn/business/2016-04/01/content_38160460.htm).

On the heels of the Franco-German text, the EU Parliament passed a resolution on China and MES on 12 May with a resounding majority of 546 to 28. The main parties were close to unanimity. No votes or abstentions are centred on the far right (which fielded its own resolution) and the two far-left groups.

The resolution takes a strong stand on the legal question, stating that WTO members will still be able to apply “special rules” and a “non-standard methodology” to imports from China after December under the remaining sections of article 15. However, it leaves considerable leeway for the Commission to interpret the resolution – though it states that China is not a market economy, it places no formal obligation on the Commission to decide on MES according to its five existing criteria. It also calls for the reinforcement of Europe’s trade defence instruments. In short, it is a remarkable effort at a way forward.

However, there are limits to what European Parliament resolutions can achieve. In the words of one experienced EU official, “the real debate has not begun”. Yet this vote may well be a landmark, because it sets boundaries for the Commission. In an era where the European Parliament has grown in influence, its resolution indicates that it will make sure that the final outcome is the product of genuine consideration by the Council and the Commission. This applies to mitigating measures specific to China, or to more general new trade defence instruments that are likely to be proposed. The Commission’s trade officials are under no illusions about the likelihood that there will be much back and forth with the Parliament and the Council after the draft proposition is submitted by the Commission: “There will be blood on the floor”, as one EU official put it.

The reasons for the Parliament’s new weight are diverse. First, because there is substantial unity across partisan lines around a text that makes strong recommendations. It may be viewed by the Commission as a mandate for action, and by China as a last call to enter effective talks rather stonewall this and other pending economic issues with the EU. Much of the climate in the EU institutions around the MES issue can be explained by close contact and communication between the Commission and the Parliament: Jean-Claude Juncker – “the most social-democratic of all conservatives”<sup>41</sup> – is said to maintain permanent contact with European Parliament President Martin Schulz, and Gianni Pittella, who leads the Socialists and Democrats group.

By tackling the MES issue, the institutions are beginning to address two other problems. One is the “democratic deficit”, whereby key decisions for the future of Europe are taken outside the Parliament. The other issue is that, unlike their US counterparts, EU trade officials have not been able to cite an independent parliamentary third power to justify their negotiating positions. China has until now dealt with the Parliament either as a pushover, or as an obnoxious but impractical actor over human rights issues. The Parliament’s role is now changing, and China is bound to take notice.

<sup>41</sup> Interview with Council official, Brussels, 26 March 2016.

## The options for Europe

In the next few months, the EU is likely to stall. Time is too short for the complex reform of trade defence instruments outlined above.

In the last six months, the EU has dramatically changed course on the issue of MES for China. As recently as February, the Commission had outlined three options: changing nothing, which would likely result in a legal clash with Beijing; changing anti-dumping criteria without putting in place mitigation measures to protect European producers; and changing the criteria with mitigation measures.<sup>42</sup>

Leaving the existing “surrogate country” criterion in place is only a short-term option. China would immediately challenge it legally. The process takes two to three years, which would offer breathing space for the hardest-hit industries. Following up with mitigation measures targeted at China would create another legal challenge. The process could conceivably be drawn out over a decade – which would not really be a win for China even if the WTO finally rules in its favour. WTO rulings do not include damages for illegal trade protection measures that they overturn.

China has often played these types of games itself, using delays and ambiguities in the legal system to avoid following the rules. But adopting this type of strategy to deal with MES would not enhance the EU’s reputation for upholding international law. This matters – if Europe breaches international law, it cannot expect others to respect it. China – along with Russia – is at the forefront of a revisionist camp that seeks to disregard or overturn international rules when they prove inconvenient. A failure by Europe to abide by the terms of a WTO treaty would be a propaganda gift to China’s government, which would denounce hypocrisy and double standards.

But, desirable or not, stalling is likely to be the course of action for the first few months after the 11 December deadline. Those involved agree almost universally that, given the EU’s lengthy decision-making processes, it will not be able to agree on a course of action by the deadline. And it seems inconceivable that the EU would remove existing barriers without mitigation measures in place. At best, the Council might issue a statement of principle on MES, but that would not include a simultaneous decision on anti-dumping. The EU is therefore moving towards a clash with China, unless there is a sea change in China’s negotiating position.

In the longer term, Europe is likely to choose option 3 – changing the anti-dumping criteria, and putting mitigation measures in place to protect producers. There are two ways this

<sup>42</sup> “Trade Defence and China: Taking a Careful Decision”, Speech by Cecilia Malmström, European Commissioner for Trade, Brussels, 17 March 2016, available at [http://trade.ec.europa.eu/doclib/docs/2016/march/tradoc\\_154363.pdf](http://trade.ec.europa.eu/doclib/docs/2016/march/tradoc_154363.pdf).



could play out. There may be measures specifically tailored to China, not unlike those already adopted against Russia. Or, as both the Parliament resolution and the Franco-German document seem to indicate, there could be part of a more general strengthening of the EU's trade defence instruments. These two options are not necessarily mutually exclusive.

Strikingly, even a producers' lobby such as Eurofer is now putting its weight behind a full revamp of trade defence instruments rather than maintaining the current anti-dumping methodology, on the grounds that the US and Canada, among others, have more effective anti-dumping methods without using the "surrogate" rule.

There is another reason for discarding the surrogate methodology. The EU already has anti-subsidy legislation that applies to market economies, in addition to anti-dumping measures that are based on price alone. Applying, by way of mitigation, a mixture of anti-dumping and anti-subsidy measures would raise two issues. One, that it is very difficult to prove specific subsidies in an economy which is structurally directed from the centre: there is simply no market price in China for land, energy, or many other inputs. Two, it is legally questionable to penalise China under both non-standard anti-dumping criteria that apply to non-market economies, and under anti-subsidy rules that are designed for market economies.

Paradoxically, the EU's anti-subsidy law<sup>43</sup> does not apply to non-market economies – because they require domestic market criteria for their application. Deeming China to be a market economy would make anti-subsidy action easier, and open the way for "double remedy", e.g. applying both anti-dumping and anti-subsidy sanctions. Finally, continuing the practice of placing the burden of proof for market conditions on Chinese firms – as provided by article 15 of the Accession Protocol – may lead to challenges with the European Court of Justice or the WTO's Dispute Settlement Body.

A more general reform of trade defence instruments is the better option for Europe. Any specific mitigation measures are likely to be challenged by China, and a WTO ruling in China's favour cannot be ruled out.

## What next?

There are good arguments for Europe adopting a flexible and open attitude towards China on the MES question. One, voiced in Germany as well as in Brussels, is that China needs help with its economic transition, and that it helped Europe during the euro crisis. Reducing China's overcapacities is a Herculean task, given the social fallout from closing factories. Some also stress the importance of good relations with China for establishing the "connectivity platform", a grand plan to enhance EU-China cooperation in Eurasia through China's One Belt, One Road initiative; to plan shared standards on the next generation of mobile networks, 5G; and to draw greater Chinese investment in European infrastruc-

ture. The first phase might be significant Chinese participation in the European Bank for Reconstruction and Development (EBRD), which would signal a willingness to invest in pan-European projects, run on European rules.

In addition, the failure to grant MES would deeply affect overall EU-China relations. It is an important status issue for China, which resents being classed alongside Belarus and North Korea by EU anti-dumping legislation.<sup>44</sup>

There is even a geopolitical argument for Europe to avoid dependence on US policies. Instead, there could be a new Sino-European "grand bargain", where Europe would exchange guaranteed market access for Chinese investment. Europe needs to ascertain the positions of its other major trading partners on this question, and the positions of members of the G-7 and G-20, in which China plays a pivotal role. Europe may be hoping that the global debate about China's overcapacity and efforts to deal with it will spare them the agony of decision. In a US election year, this does not look very likely, since the outgoing administration does not need to decide on this, and most likely will not do so.

Insiders in past talks and negotiations scoff at these ideas. Helping China with its transition would be fine if China helped itself – i.e. if it visibly moved forward with structural reforms. But these seem to have been slowing or stalled since autumn 2015. China's transition touches on sensitive social issues in China, but it does in Europe too, where the steel industry has already undergone severe restructuring. European steelmakers were beginning to see increased demand in the last two years when Chinese exports hit. The connectivity platform and One Belt, One Road are mostly about Chinese interests. One European official involved in the debate said in an interview that he could not bear to hear these terms anymore, and advised the EU to let Beijing come up with concrete proposals instead of doing its homework for it.<sup>45</sup>

While the idea of a grand bargain that would swap MES for a bilateral investment treaty (BIT), or even Chinese investment in the Juncker fund, is attractive, it is totally unrealistic. Chinese officials have indicated that they will only discuss the treaty *after* MES is granted, and that their investment deals are purely bilateral, and made on the basis of business alone. One expert on the so-called 16+1 annual summit of Central and Eastern European states with China noted that China's model for this was FOCAC, its summit with African states: a front of nice speeches, and deals that are purely bilateral as opposed to regional. In fact, the investment terms required by China were such that only the non-EU members, free of EU rules, could avail themselves of the offers.

Most of all, according to an official from the EU Council, "China has not helped us to help it", by turning down many opportunities for economic dialogue and sticking to what it believes to be the letter of the WTO agreement, rather than negotiating.

In an effort to extricate the EU from the legal trap it set for itself with its anti-dumping legislation, the Commission and

<sup>43</sup> Its consolidated version is available at <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:02009R0597-20140220>.

<sup>44</sup> Interviews with EU officials, Brussels, 23 May 2016.

<sup>45</sup> Interview in Paris, 20 May 2016.

the Council have begun to raise the stakes. The clean way out of the legal entanglement is a reform of trade defence instruments – which will have wider implications as it applies to all trade partners.

But trade defence instruments are even more of a sensitive issue than MES itself. Their reform implies more power, and more human resources, to the Commission, clashing with the renationalisation of policy in recent years. At stake is “the very survival of EU trade policy”, according to one insider. Others take a more optimistic view. They note that Europe has stuck together, in spite of major differences, in implementing sanctions against Russia after the Crimea–Ukraine crisis.<sup>46</sup> European unity might also be possible on trade relations with China, if this is considered a vital issue by policymakers.

The healthier economies in the EU – those with large trade surpluses and strong growth – are those that stand to lose most from the unwanted side effects of new trade defence instruments. Indeed, these new protective measures would need to be WTO-compatible, and other WTO members would likely adopt them – including against European exporters.

For France and Germany – respectively, a country with a large trade deficit, and the country with the world’s top trade surplus after China – to reach a preliminary agreement is an important step.

It is very difficult to outline at present what a compromise solution would be, and, perhaps almost as important, what China’s response would be. The Commission’s trade department, DG Trade, appears unconcerned by the fact that the debate over how to deal with MES is likely to continue into the final months of 2016. As the deadline looms, it will be even more difficult to extract concessions from China. Speed is of the essence if the EU does not want to be overtaken by events.

## Recommendations

What shape should the EU’s decision take? Here are some points for consideration:

1. The European Council should announce its intention to grant MES to China. This makes sense for several reasons. First, the term “MES” is poorly defined, and denying this status creates an unnecessary conflict over symbols rather than policy. Second, it would encourage China to move towards a market economy – as it appeared to be doing when it joined the WTO 15 years ago. Though China is not a market economy, it has actors that would thrive under market conditions. Third, it would prevent accusations of unfairness. The international community indirectly promised in the WTO Accession Protocol that China would be granted this status, although probably not in terms that are legally enforceable. Fourth, MES is a contentious issue with some of the more anti-protectionist member states, who, if there are enough of them, could block a reform of trade defence instruments.
2. However, the EU should leave its anti-dumping legislation unchanged for now, as a full reform of trade defence instruments is clearly not possible before 11 December, and a British exit from the EU could delay the process further. This creates an uneasy period where China may choose to legally challenge the EU at the European Court of Justice or the WTO, and even fight a trade war. Cooperation with other G7 and possibly G20 members is therefore essential to avoid Europe becoming isolated. It should try to reach an understanding with China that the surrogate criteria for dumping cannot be rescinded until other measures are put in place. The “grandfather clause” – allowing the EU to continue the anti-dumping cases initiated before 11 December with unchanged criteria – is unlikely to be overturned by the WTO.
3. The EU should make a renewed effort to push China to commit to economic dialogue, and more importantly to taking measures to guard against sudden surges of exports. China should also return to the earlier practice of cancelling VAT rebates on exports. However, under WTO principles this could only be a unilateral and voluntary decision by China.
4. The Franco-German paper makes a series of useful proposals for the reform of EU trade defence instruments. As it sets out, any mitigating measures or alternative anti-dumping criteria must take into account the fact that the price of inputs into manufactured goods is structurally distorted in China. As a result, it is not possible to use domestic Chinese prices as a standard to identify dumping. Therefore there must be an element of international comparison, whether this is temporary and based on the precedent of Russia, or as part of a more general reform of trade defence instruments. Estimates of costs by the Commission could be utilised to challenge Chinese subsidies. It should then be possible for China or relevant sectors and firms to present evidence that the prices did not amount to dumping.
5. The Commission’s role and resources must be increased if it is going to be an effective instrument for combating Chinese dumping. The Franco-German paper’s proposal to apply the conditions used for Russia on issues such as raw material and energy pricing are insufficient in the case of China: the price of land, and financial subsidies, matter as much or more. Identifying unfair subsidies is difficult, because it requires greater human resources and access to demonstrate their existence.
6. As suggested in the Franco-German draft, the Commission should not need a complaint by a third party to take anti-dumping action. This will free European firms operating in China from the pressures that prevent them from speaking out publicly.

<sup>46</sup> Interview with Council official, 31 May 2016.

Free trade in goods, and the GATT–WTO legacy of agreements, is a foundation of international trade, one that has enormously benefited Chinese producers. It is also an issue of the past – liberalising services and finance, opening up public procurement, and establishing universally applicable norms on safety, environmental protection, and intellectual property are the issues of tomorrow. As China becomes a world-class economy, it must recognise that it is high time that it fulfil the provisions of articles 1 to 14 of its WTO Accession Protocol. In 2001, they constituted a roadmap towards a free and competitive economy, even if the Protocol failed to spell out the deadline, legal implications, or even process. It is against these unspecified commitments that article 15, also left legally unclear as to some aspects, was adopted. It places a corresponding responsibility, but not a legal obligation in some cases, for China’s trade partners to declare it a market economy in due course.

For Europe, this is particularly challenging, because of its diverse interest, and the other simultaneous crises that challenge its unity and ability to act. Yet the capacity to carry out successful trade negotiations, and promote a free and rules-based environment, remains the heart of the European process, one which unites currents otherwise in disagreement regarding the extent of European competences. The outcome of the twin debates, on China’s MES and on modernising the EU’s trade defence instruments, will be a test of Europe’s capacity to stay ahead as a beacon on global rules and to implement the European interest.

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