

# China market economy: status update

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## Summary

*The debate has now started in earnest over whether the EU will - or must - award China 'Market Economy Status' (MES) in 2016. The status is politically sensitive for Beijing, but has no technical standing outside of EU nomenclature. However, it is linked to one very specific and narrow element of EU trade defence practice where the material impact for some businesses competing with Chinese imports is potentially very significant. The debate around MES in the EU is going to combine heated disagreement on the meaning of a fifteen year old treaty, EU-Chinese political relations and a liberal dose of globalisation anxiety. So how much does the decision actually matter and how will it get made?*

The debate has now started in earnest over whether the EU will - or must - award China 'Market Economy Status' (MES) in 2016. The status is politically sensitive for Beijing, but has no technical standing outside of EU nomenclature. However, it is linked to one very specific and narrow element of EU trade defence practice where the material impact for some business is potentially very significant. So how much does the decision actually matter, and how is it likely to be made?

The MES designation is important in EU practice solely because of its role in calculating the costs of production in markets subject to EU anti-dumping and anti-subsidy investigations. WTO rules require that these costs be calculated on the basis of data gathered from the market subject to investigation, except where that economy can be shown to be a 'non-market economy' in which prices are widely distorted by state ownership or intervention.

In these cases, prices can be 'reconstructed' using data from markets of a similar size and nature where market conditions apply. In general, this practice is not applied to

other WTO members - WTO membership is commonly seen as incompatible with such levels of state intervention - but China's WTO 2001 accession agreement specifically provided scope for treating China as a non-market economy until individual WTO members designated it otherwise. This freedom will lapse in December 2016.

## The Chinese price

What exactly this means in legal and practical terms is the essence of the current debate and is hotly contested. The material question from a WTO point of view will be whether or not the EU (and others like the US) will continue to use non-Chinese data to construct Chinese prices in trade defence cases, and in what way. There is some leeway in WTO law and jurisprudence for using non-market data at the level of individual companies or sectors in investigations where real data cannot be secured or relied on for some reason. But treating Chinese data as a whole as unreliable for the purpose of trade defence cases seems incompatible with the 2001 agreement. If the EU appears to be doing this, a Chinese WTO challenge seems inevitable.

What does this imply about the actual granting of MES status to China? In principle this designation is based on a series of five tests established by the EU in the late 1990s. These relate to factors such as the transparency of prices and the reliability of accounting practices and they are always presented as (if not seen as) empirical and objective, so the European Commission will have to produce some pretty clear and compelling evidence to back up any fortuitously-timed assertion that China has now passed them all. Past granting of MES to Russia (2004) and Ukraine (2005) set a clear precedent for fudging some of the detail for political reasons, and there is some reason to expect the same here.

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### The five MES tests

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Decisions by firms regarding prices, costs and inputs are made in response to market signals, without significant state intervention.

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There are no significant legacy distortions in the economy from the previous non-market period.

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Firms in the economy operate under transparency, bankruptcy, property ownership and corporate governance laws.

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Firms in the economy operate under a single set of accounting standards based on international norms, applied in all circumstances.

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Exchange rate conversions are carried out at a market rate.

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The link between granting MES and a change of trade defence practice in 2016 is debated. There is nothing in current EU regulation that links the use of ‘non-market economy’ methodologies in investigations to MES explicitly. The EU regulation also does not explicitly list China as a ‘non-market economy’ as it does, for instance, in the case of North Korea, Belarus or Azerbaijan. As such, granting MES means striking China off a list referred to in the regulation, but not changing the current 2009 regulation itself.

Under some interpretations of the 2001 Chinese accession agreement, the granting of MES - as the EU’s domestic system of recognising a market economy - removes a current burden of proof on China to show on an industry-by-industry basis that market conditions prevail. The text does not place a limit on the timeframe in which this requirement on Beijing might apply. However, irrespective of whether MES is actually granted, the systematic use of non-Chinese data at *the level of the whole Chinese economy* appears to be fairly clearly proscribed after 2016 in the Chinese accession agreement. So both steps are material, especially the latter.

For the sake of legal clarity and security, the European Commission would probably want to revise the regulations to explicitly state where it believes it still has scope for using non-market data even in markets

that do not have ‘non-market economy’ status, or which have been granted MES. The Commission also seems to be looking at salvaging from the failed 2013 attempt to upgrade the EU’s trade defence instruments a number of proposals that would allow the EU to impose duties faster in investigations. The two lots of changes would allow the Commission to both drop the systematic use of non-country data and look tough on China at the same time.

### Impact at the margins

What are the potential impacts for EU businesses competing with Chinese imports, or relying on Chinese intermediate goods? The key point is the likely change in trade defence practice after 2016. The EU currently uses an ‘analogue country’ test in Chinese investigations, in which data from other countries such as Brazil or the US is used to model Chinese prices in trade defence investigations. This almost certainly produces higher dumping and subsidy margins and subsequently higher duties on dumped or subsidised imports. Without the analogue country test, duties will potentially be lower, and it is also possible that there will be fewer cases in which a dumping margin in China is found at all. For large users of the trade defence system such as the steel and textile industries, this is material.

However, EU trade defence officials have been carefully probing WTO law for other ways of using non-market data in trade defence investigations. The 2001 agreement suggests that so long as MES status has not been awarded there will be scope for requiring Chinese industries to prove that they meet market economy conditions to avoid the use of non-Chinese reference data. The Commission has thus far not suggested that it wants to test this point by withholding MES itself, but it may yet be pushed in that direction.

Even then the Commission has been testing the legal scope for using non-country data, including in markets that have been granted MES. In certain investigations in Russia, Argentina and Indonesia, the Commission has used reference data from outside of these countries on the basis that ‘hidden’ or ‘implicit’ export subsidies rendered domestic prices unfairly low. This practice has been challenged in the WTO, but EU officials are confident that WTO law provides some scope for doing this in future. This would allow the EU to use non-Chinese prices on a company-by-company or sector-by-sector basis in future investigations. However, it would inevitably be challenged by Beijing.

As the process unfolds over the next few months a few developments will be key. The first is the precise detail of the Commission’s recommendation on whether to grant MES, and if so to what sectors or to the whole Chinese economy. The Commission needs to balance its own strategic relationship with Beijing and the knowledge that a number of large members states and big parts of the European Parliament are opposed to what they see as unilateral disarmament in the

trade defence system. It has already signalled that it sees its hands are tied by the 2001 agreement and is likely to recommend granting MES - a decision that in principle could be subject only to a negative veto from Member States and closely watched by the European Parliament. The US has already signalled that it will not grant its own version of MES - so people will be watching the US example. If the Commission declares the five MES tests passed it can expect robust scrutiny.

The second is what happens in trade defence cases after December 2016. Even if MES is not granted, a refusal to change trade defence practice after December is the key trigger for Chinese retaliatory action. Even if MES is not granted the Commission will have to make a decision about whether to use the analogue country test in the knowledge that it would almost certainly be challenged if it did. But dropping the test would also provoke loud protest from industries that currently benefit from the higher margins that current practice produces.

The third is whether there is an attempt to change the EU Anti-Dumping Regulation and how. This is most likely if the Commission was to seek to establish more clearly where it believes it has scope to use reference prices over local data in investigations. It may also seek to give itself other tools for use against China such as faster provisional duties. This will require European Parliament and European Council approval and in both cases the bias will be to a tougher line on China, so this route could mean more eventual legal certainty, but will wind up Beijing.

Over the last fifteen years, MES has taken on totemic political status for Beijing. Because of the tests established to underpin it, the Commission would in fact be making a very bold and potentially credibility stretching claim about the scale of Chinese reform and state withdrawal from the economy if it was to declare them passed. What is material is what it then actually does in trade defence cases. This change will merge into a larger political debate about globalisation, fair competition from China and the ability of the EU to defend itself from unfair trade practices - irrespective of what it might have committed to fifteen years ago in Geneva.

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