25 June 2015

Assessment of the normative and policy framework governing the Chinese economy and its impact on international competition

Executive Summary

For:

AEGIS EUROPE
Brussels
Belgium

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EXECUTIVE SUMMARY

This study examines the distortions in the Chinese economy that make it unsuitable for consideration as a market economy for the purposes of EU trade defence law.

Among the key elements examined in the Study are:

- the continued and central role of the Chinese Communist Party in the economy;
- the 71 detailed five-year government plans directing and managing the economy;
- the 22 national industrial sector plans;
- the Provincial and Local plans implementing national industry plans;
- the role of industry associations as arms of the state;
- the limited role of markets for consumer goods only;
- the absence of markets for capital, labour, land, energy and other factors of production;
- the pragmatic subordination of markets to state planning;
- the absence of true competition rules, bankruptcy laws and market exit mechanisms;
- the tools restricting imports into the Chinese market;
- the tools managing and directing exports to international markets;
- the state control and direction of outward foreign direct investment;
- the state direction and control of inward investment and ownership.

By analysing a very substantial number of primary Chinese documents, as well as secondary sources and academic studies, the study shows the inter-relationship between commercial enterprises and the Chinese Government as well as the Chinese Communist Party. It is this inter-relationship which guides commercial enterprises, not the market. Markets only play a secondary role.

Economic activity and the allocation of resources in China continue to be predominantly determined by a broad array of governmental programmes, subsidy schemes and arrangements to punish or promote specific behaviour. As a result, nearly fifteen years after accession to WTO, the patterns of economic interaction in the Chinese economy remain highly distorted and reflect neither the true scarcity of goods and resources nor the competitive strengths of market players.

Thus, China does not currently meet the criteria used by the European Union to evaluate whether an economy has made the transition from a state controlled market system to a normal market economy. The study shows that granting market economy status to China, when it does not meet the technical criteria to be considered a market economy, will be devastating for manufacturing in the EU. It will hit jobs, growth and innovation in industrial sectors made up of both small and medium sized enterprises and large scale transnational companies.

A More Detailed Summary of the Report

The study is divided into three parts covering:

- The Chinese Economy: Centralised Planning and Control Mechanisms
- The Interface with Global Markets
- The Impact of the Chinese Economy on the Global Economic System

Each of the three parts is divided into a series of sections and sub-sections covering more than 350 pages with 10 Figures, 85 Tables and 13 Boxes illustrating details of the functioning of the Chinese economy in practice. The tables show, for example, an overview of the State Planning System. The 85 tables show, for example, the different recipients of different support programmes with exact amounts of subsidies received. The boxes list for example the 83 five year plans currently framing the development of most sectors of the economy.

Part I: The Management of the Chinese Economy: Institutional Set-up and Policy Instruments

Chinese government organisations, at all levels of the national hierarchy, seek to control the economic activities of individual business entities and to direct their behaviour in directions considered necessary for the realisation of goals already fixed at the national level (Chinese Communist Party as well as the national government), the local and the individual levels. This Part of the Report demonstrates that this phenomenon is reflected in the complex system of planning documents that guide all economic activities in China (section 2.1) as well as a substantial number of specific programmes targeting specific objectives and developmental goals (section 2.2). In this context, the market is nothing more than a complementary instrument with a limited role on the allocation of resources, depending on sectors and products covered (section 2.3.)

<u>Chapter 2.1: Centralised Planning in the Chinese Economy</u>

Centralised planning has evolved over the years but change does not mean the plans are any the less centralised or controlling in their nature for that reason. A major change was implemented with the *10th Five Year Plan* (covering the period 2001-2005). At this time the tradition of providing concrete output-target figures was discontinued. Instead indicative planning mechanisms and indirect means of control and regulation were introduced. From the *11th Five Year Programme for Economic and Social Development*, covering 2006-2010, onwards, even the term 'plan' has been abandoned and been substituted for the label 'programme'. These new "Five Year Programmes", however, are no less comprehensive and complex than their 'plan'-forerunners. Like their predecessors, they comprise much more than just China's central government's vision and general outline for national economic development.

The plans operate at all levels of the economy. There are six levels of hierarchy in China from the Central to the Local. Each sub-level develops its five-year plan on the basis of the plan of the level above. Plans are also developed along Institutional lines for examples each government department will have its own plan, as well as on the basis of topics of concern such as air pollution or water conservation. Finally there are the sectoral plans which are developed industry sector by sector, again at various levels of the hierarchy and on the basis of groups of sectors with similar features.

Box I (page 36 of the Report) lists some of the more relevant sectoral plans. It can be seen that there are plans for Aluminium, Animal Feed, Automobiles, Ball Bearings, Bee Keeping, Biomass, Cement, etc. ending up with Vegetable Oils and finally the Wind Power Industry. The report lists 71 plans. No segment of the economy is excluded.

Box 2 (page 38 of the Report) lists the Key Technology Programmes for the 12th Five-year plan. There are 22 of these plans covering Basic Research, Broad Band Networks, Clean Coal, Cloud Computing, Commercialisation of new technologies, High Grade Steels etc up to Tourism, Waste Recycling and Wind Power.

In 2005, the State Council ruled that

> *"the people's governments of all provinces, autonomous regions, and municipalities directly under the Central Government, the relevant administrative departments of the state for development and reform, public finance, taxation, land resources, environmental protection, industry and commerce, quality inspection, banking supervision, electric power supervision, work safety supervision, as well as the administrative departments of all industries, etc. shall establish and improve the mechanism for organisation, supervision and inspection of the industrial structure adjustment work, perform their respective duties, cooperate with each other closely, form a resultant force, and effectively intensify the effectiveness of implementing industrial policies"* (State Council 2005a in the preamble)

Chapter 2.2: Dedicated Government Programmes for the Guidance of Industry

The Chinese government remains committed to a hands-on approach to economic development. **Industrial policies are employed to provide guidance to economic actors and steer the economy towards specific goals.** This chapter examines some of the most important policy programmes. In this context the specific mechanisms that are employed in order to steer enterprises and whole industries in specific directions are outlined.

Among other features, these programmes provide significant subsidies to Chinese commercial entities. The Report shows that China has not fully reported all subsidy programmes to the WTO as required by its WTO Membership. The first notifications in 2004 were thin and those in 2011 condemned by many WTO members as being insufficient.

Anti-subsidy investigations in the EU, the US, Canada, Australia and other WTO members have identified numerous grant giving operations conducted by the Chinese central government that were not included in the notification – many of which have been found to violate anti-subsidy law. Several academic and commercial studies have discovered numerous instances where subsidy programmes, tax breaks, discount loans and related measures have conferred unfair advantages to selected industries and enterprises (e.g. Price et al 2006; Price et al. 2007; Dewey & Le Boeuf LLP 2007; Haley 2008; Haley and Haley 2013; Ogilvy Renault LLP, 2007; Taube and in der Heiden 2009).

China's 2004 notification provided no information at all about industry support programmes and grant giving schemes operated by the country's 33 provincial and about 850 municipal-level jurisdictions. This fact is particularly relevant as the Chinese political-economic system transfers most policy implementation matters to the local government level. Furthermore, provinces, cities, districts and counties bear the responsibility for developing local economies and use financial incentives to compete for investment projects. Both factors suggest that subsidisation is prevalent and that most objectionable practices are anchored on lower administrative levels. The omission of subsidy programmes administered by sub-central governments thus creates a very large blank spot in the notification.

In 2011, China submitted its second subsidy notification which covered the period from 2005 to 2008. The second document displays the same shortcomings as the first and has to be considered significantly incomplete. Information provided on subsidy schemes administered by central government authorities was again found to have large gaps and again, not a single programme run by sub-central government bodies was mentioned. Overall, China did not honour the commitments it accepted at the time it joined the WTO in a complete, consistent and transparent fashion. It failed to disclose all relevant information in a timely manner. It also failed the obligation to publish policy documents on trade-related measures translated into at least one of the organisation's official languages in a single official journal.

Recently the United States has initiated WTO dispute settlement against China on the basis of 300 programmes identified by the US Department of Commerce. In addition. THINK!DESK has identified a number of subsidy programmes which appear to be unrelated to specific policy plans.

This Report, from pages 45 to 137 lists a whole series of subsidy programmes that it has been able to uncover on the basis of published programmes as well as the financial reports of a series of commercial entities.

A key conclusion is that China backs up its five-year plans with subsidies. However the provision of subsidies is only one feature of the Chinese way. The very fact of the plans and the willingness of commercial entities to comply with them is a central cartelizing feature of the Chinese economy.

Chapter 2.3: Industry Associations carry out government functions

China's industry associations differ significantly from the standard concept of the role and function of industry associations are supposed to fulfil in market economies, as understood in the OECD framework. They are not restricted to representing the interests of their respective industries and member firms vis-à-vis the government and other market participants. In addition, China's industry associations double as spokespersons for government policies and interests and undertake regulatory functions on behalf of government. In these organisations the borderlines between "the regulated" and "the regulator" become blurred.

The role of the industry associations has expanded all the more with the abolition of certain line ministries. First these became bureaus only and slowly been converted into industry associations. The historical development of many associations shows the origin in the old Ministries. This can be seen for example in the metallurgical industry. In 1998 the Ministry was downgraded to a bureau and then in 2013 the responsibilities were transferred to the CISA, the China Iron and Steel Association. Besides data collection and the provision of consultation services the main responsibility of CISA is to maintain industry discipline. Boxes 4 (on page 140) and Box 5 (on page 142) of the Report explains this development in detail.

Today, 16 industry associations have formed out of the old line Ministries The private sector is also organised in the All China Federation of Industry and Commerce. (ACFIC). ACFIC, however is a bottom-up lobbying organisation in name only. The true role of the Federation as an agent of the CPC and government is set out on its homepage as follows:

> *"Established in 1953 under the leadership of the Communist Party of China, the All-China Federation of Industry and Commerce (ACFIC), also known as the All-China General Chamber of Industry and Commerce (ACGCIC), is a group of the masses and a chamber of commerce oriented toward the business circle and with the enterprises and personages of the non-public economy as its main entity. It is a channel for the CPC and the government to liaise with the personages of the non-public economy, and an aide of the government in administering and serving the non-public economy. The work of ACFIC is a key component of the CPC's united front and economic work. The cause of ACFIC is an important part of Socialism with Chinese characteristics."*
> (ACFIC, n. d.)

2.4: The subsidiary role of Markets in China

The litmus-test for the existence of a market system is the prevalence of prices that truly reflect relative scarcity, i.e. the relation between demand and supply of the factors of production as well as goods and services, based on the preferences of all individuals in an economic community. In a well-functioning competition-based market economy, scarcity-based prices are responsible for the allocation of the resources available in an economy as well as the economic selection of investments and products.

Since the start of economic reforms in the late 1970s China's policy makers have gradually increased the scope that markets and supply-and-demand determined prices are allowed to play in the national economy. **However, even though prices are beginning to have a role, the extensive network of planning documents and governmental guidance, prices are still not allowed to play a decisive role for the coordination of economic activity in most areas of the Chinese economy.** Comparing various segments of the Chinese economy, it can be seen that prices do have an increasing role for consumer goods. However, the further up the value chain the analysis advances, the more restricted the role of markets and prices becomes. The prices of raw-materials and basic inputs to the production process continue to be strictly controlled and guided by the Chinese state and do not fully reflect the true degree of scarcity in the economy. And with regard to the allocation of the factors of production, i.e. capital, labour, and land, scarcity-based market prices eventually play only a subordinated role, being more or less entirely overshadowed by discretionary interventions of government bodies in the allocation process (Huang 2010a, Chen 2014).

This chapter looks at the role of scarcity-based market prices play in various segments of the Chinese economy in greater detail. Starting with the function of prices for the allocation of the factors of production, namely capital, labour and land it moves on to pice setting mechanisms for raw materials, utilities as well as commercial goods and services.

Box 6 (on page 153 of the Report) looks at how the government controls the allocation of bank loans in Hubei Province. Box 7 (on page 154 of the Report) does the same for Gansu Province.

In the Chinese **capital markets** the price signals generated on the markets are subjected to government induced distortions first of all due to a repression of interest rates and a manipulation of the exchange rate. Both factors result in a constellation where capital is made available at too low prices and is utilised excessively by those having access to the formal financial system – which are China's state-owned enterprises and those actors upholding close relationships to local government agencies. According to calculations by IMF staff this has resulted in an investment ratio ten percentage points above its equilibrium value and costs to the economy in a range of about 4% of GDP per year (Lee/Syed/Liu 2012, Geng/N'Diaye 2012).

The **price of labour** continues to hover below its “fair” value due to an expressed low wage policy by Chinese government – at least until the recent initiative to boost domestic consumption –, highly immature wage bargaining processes and the household registration system (*hukou*) which prevents the constitution of a unified national labour market by effectively discriminating against labour originating in rural areas. These factors plus an inconsequential enforcement of social security systems result in a situation where firms are allowed to acquire labour with lower skill levels at bargain prices and expand business models making extensive use of such labour input.

Chinese **land markets** feature even higher degrees of distortion as on the one hand prices for commercial land use rights (LUR) are pushed up by local governments in order to generate high revenues from land sales. While on the other hand inter-jurisdictional competition for industrial investments pushes prices down for corresponding land uses. As such industrial LUR have been featuring much lower price increases (multiplied by a factor of 1.55 between 2000 and 2013) than LUR for commercial land (multiplied by a factor of 6.7) and residential land (multiplied by a factor of 4.5) (Chen 2014). As a result the allocation of land becomes removed from the true (national) economic necessities and rather favours industrial business models requiring large stretches of land.

The greatest distortions but in recent years also greatest improvements have been achieved with respect to the **pricing of nature**, which economists have in recent years learned to include in the concept of “land” as an elementary factor of production. After decades of reckless growth-fetishism, the wish to contain the on-going degradation of natural environments and attach a price to environmentally hazardous business activities has eventually become a major driver of social activism and elite policy making. As such the distortions resulting in an over-utilisation of natural environments are continuously being dismantled allowing for a better allocation of these resources.

The total costs these multifaceted distortions in the allocation of resources convey to the Chinese economy as a whole can only be estimated. Huang and Tao (2011) estimate the aggregate costs arising from the governmental interventions in the factor markets to lie in the range of about 10% of Chinese GDP each year during the first decade of the 21st century.

Chapter 2.4: Competition authorities, bankruptcy and market exit mechanisms

The Chapter also looks at some specific complementary market institutions that have to be in place in order to make the competition based pricing system work correctly. Markets can only direct economies towards high levels of welfare and development, if the signals generated are actually executed in the market place. Complementary institutional arrangements need to be in place, incentivising economic actors to act according to market signals. In order to uphold their capability to signal the best allocation of resources and goods in the economy, markets must furthermore be protected from a one-sided accumulation of power that might interfere with efficient competitive processes.

The chapter concludes that China has yet to implement these complementary market functions in a way that incentivises, or guides, economic actors. The state, through the five-year plans, remains the main guidance and incentive.

Functioning markets rely on the principle that the most productive and “best” players as determined in fair competitive processes are rewarded by being enabled to actually engage in business transactions and participate in the division of labour. As a consequence, however, functioning market systems must also make provisions for those market players that are rejected by the market. Firms which cannot compete successfully must be allowed to leave the market in an orderly manner.

Bankruptcy cases in China are relatively rare considering the size of the economy and population as well as the speed with which the country is transforming itself. Statistics provided by the Supreme People’s Court indicate that only 2,059 bankruptcy cases have been filed with Chinese courts in 2014 (Supreme People’s Court 2015). The small number relative to other countries may be partly explained by the fact that China does not allow for private bankruptcy. However, an even more striking finding is that the number of cases in China has dropped substantially in recent years. For 2010 and 2012, the case count stands at 3,573 and 2,531 respectively (Supreme People’s Court various years).

A new bankruptcy law went into effect on June 1, 2007 (NPC 2006b). It eliminated provisions for policy bankruptcy effective January 1st, 2008 and thus reduced the incentives for SOE to seek bankruptcy protection. However, comparing to bankruptcy regulation in other countries, the new law is still relatively thin.

While the new law has added essential regulation on the handling of restructuring plans and debt disposition, it still has several limitations. The new law has a much wider scope as it covers bankruptcy of SOEs as well as private companies, foreign companies and Sino-foreign joint ventures. However, there are still no regulations governing insolvency of private individuals, public institutions or sole proprietorships. Furthermore, the new law offers little guidance for bankruptcies of banks, securities or insurance companies. Article 134 touches upon this briefly but refers to other laws and regulations that should be issued by the State Council.

Chapter 2.5: Markets and market players are subordinated to State interests

The Chinese Communist Party and Chinese government organisations continue to intervene massively in the economic process. Rather than establishing a sound macro-economic control system and an industry-oriented regulatory framework in which market forces determine the patterns of economic interaction, China’s ruling elite believes in its ability to design an economy by decree which achieves better outcomes and higher economic dynamics. Its strategic aspirations and normative

goals for the economy and its sub-sectors are outlined in a broad array of planning documents. These are complemented by a large arsenal of dedicated policy instruments which are designed and employed to steer economic agents towards these goals. <u>15 years after accession to WTO, markets continue to play only a subordinated function in the overall working mechanism of the Chinese economy</u>.

The strategic aspirations and normative goals of Chinese government for the economy and its sub-sectors are outlined in a broad array of planning documents. These are complemented by a large arsenal of dedicated policy instruments which are designed and employed to steer economic agents towards these goals. 15 years after accession to WTO, markets continue to play only a subordinated function in the overall working mechanism of the Chinese economy. In the word of renowned China scholar McNally:

> *"The defining characteristic of [China's] modern state capitalism in comparison to liberal market capitalism is in the end a considerable distrust of markets and full-out economic liberalization. This does not mean that markets are unimportant, but that markets are used pragmatically." (McNally 2013, p. 50)*

<u>Chapter 3: the Role of the Chinese Communist Party</u>

In addition to Chinese government's aspiration to guide industrial development, large parts of the Chinese economy in general and its industry in particular are subject to the direct control and governance of the Communist Party of China (CPC). The CPC reserves for itself a prominent role in economic matters, including the operation of commercial entities. 35 years after the onset of the economic reforms, the CPC has not relinquished its role in shaping economic behaviour at the grass roots level. The constitution of the CPC provides:

> *"In a state-owned or collective enterprise, the primary Party organisation acts as the political nucleus and works for the operation of the enterprise. The primary Party organisation guarantees and oversees the implementation of the principles and policies of the Party and the state in its own enterprise and backs the meeting of shareholders, board of directors, board of supervisors and manager (factory director) in the exercise of their functions and powers according to law. It relies wholeheartedly on the workers and office staff, supports the work of the congresses of representatives of workers and office staff and participates in making final decisions on major questions in the enterprise. It works to improve its own organisation and provides leadership over ideological and political work, efforts for cultural and ethical progress and the trade unions, the Communist Youth League and other mass organisations.*

In a non-public economic institution, the primary Party organisation carries out the Party's principles and policies, provides guidance to and oversees the enterprise in observing the laws and regulations of the state, exercises leadership over the trade union, the Communist Youth League organisation and other mass organisations, rallies the workers and office staff around it, safeguards the legitimate rights and interests of all quarters and stimulates the healthy development of the enterprise." (CPC 2013 at 32)

The Report (see page 236 et seq.) details the overlapping roles between individual CPC members and specific enterprises. A systematic survey on 130 top leaders of SOEs controlled by the central government has been carried out by Li Cheng (2011) before the leadership transition of 2013. Li found that all of the 130 individuals were party members and that

- 59 simultaneously served as general manager and (deputy) party secretary
- 14 simultaneously served as general manager, board chairman and (deputy) party secretary

Other top managers of major Chinese corporations are simultaneously directing the operations of their firms and serving on the CPC Central Committee or the Central Commission of Discipline Inspection. Tables 62 and 63 (pages 242 and 244 of the Report) document prominent cases of the last years of the Hu/Wen administration.

This peculiar relationship between the Chinese State (i.e. the CPC and the government) and the business sector highlights the specific character of the Chinese economic system, which Bai/Hsieh/Song have been classifying as "Crony Capitalism with Chinese Characteristics" (Bai/Hsieh/Song 2014, 2). They understand that in this system "a *sine qua non* of successful capitalists in China is that they need to be cronies of political leaders" (Bai/Hsieh/Song 2014, 2). Given the deficient state of the formal institutional setting in China, the authors judge "the only way for entrepreneurs to succeed is to form special relationships with political leaders, which allows them to either break the formal rules or to obtain exclusive access to resources" (Bai, Hsieh and Song 2014, p. 2).

Part II: The Chinese Economic System at the Interface with the Global Markets

The second p of the Report investigates the organisation of the interface between the Chinese economic system and the global market system. It studies in how far at this critical junction of the global division of labour Chinese government organisations are intervening in market processes as well.

Chapter 4: Foreign Trade

The principle agency tasked with all matters related to foreign trade is the Ministry of Commerce (MOFCOM). Much of the current regulatory framework for foreign trade policy is laid out in the Foreign Trade Law of the People's Republic of China (NPC 2004c). MOFCOM drafts policies, overseas their implementation and maintains control mechanisms to sanction rule violations. Like all ministries and commissions of the central government, MOFCOM is subordinate to the State Council, China's cabinet. The State Council deals with foreign trade on a more selective basis and makes decisions on questions of long-term strategic importance for the national economy and public welfare.

The Chinese government also reserves itself the monopoly right to import a variety of commodities. Under regulation in force in May 2015, only selected SOEs are approved to handle imports of certain grains but also of sugar, cotton and tobacco. Table 62 provides a detailed overview. Other policy programmes identified in the Report include extensive import substitution schemes and state trading arrangements.

In order to promote export activity as well as steer the composition of China's total export volumes, Chinese government agencies continue to employ a broad range of instruments and dedicated policy programmes. This policy programmes include Export Constraints, Value Added Tax Rebates, Export Duties, State Trading, Export promotion, Export Subsidies, Prizes for Export performance, matching export performance with subsidies, Famous Brands export programme, Provincial Export Support Funds, and finally the Demonstration Bases programme.

Chapter 5.1: Inward Foreign Direct Investment

Throughout the 2000s, China has been the largest recipient of FDI among all emerging markets and developing countries. Inflows surged after China had joined the WTO in 2001 and growth rates remained high until the world financial crisis. In 2008, the value of FDI actually utilised had reached 95.3 billion USD. After a slight dip in 2009, growth resumed, albeit at a slower pace. Since 2011, inflows have stagnated at about 119 billion USD.

The Chinese government continues to regulate and restrict foreign direct investment in spite of a stream of previous reforms and liberalisation announcements, e.g. following the third plenum of the 18th CPC Central Committee in November 2013. After China joined the WTO in 2001, a large number of sectors were opened to overseas investors and China has acted largely in line with its liberalisation commitments from the accession protocol. However, by the time of writing in early 2015, a significant number of business areas still remained closed off for foreign direct investment (FDI) as the Chinese government sought to protect the market position of domestic companies in general and SOEs in particular.

The most recent revision of the *Catalogue for Guiding Foreign Investment Industries* was released by the NDRC and the MOFCOM on March 10th 2015 and entered into force one month later. It contains a total of 349 individual technologies and, like previous documents, divided them into three categories: encouraged, restricted and prohibited. Overall, the *Catalogue* opens more sectors of the Chinese economy to foreign competition and removes ownership restrictions in some areas. The number of restricted and prohibited items was cut while that of encouraged items increased. Starting from April 10th 2015, foreign invested enterprises (FIE) are explicitly encouraged to build and operate urban subways, light rail as well as other means of rail bound passenger transportation systems. The need for a domestic joint venture partner was eliminated. Wholly foreign owned accounting and auditing companies are encouraged as well, as long as the leading partner is a Chinese national. Similarly, FIE are welcome to construct and operate grids together with a domestic counterpart as the major shareholder.

The restricted category was streamlined compared to the 2011 document as the number of restricted areas dropped from 79 to 38. Restrictions were lifted on the production of drugs, chemicals and general apparatuses as well as several other manufacturing industries. In the service sector, FIEs are now allowed to build and operate high grade hotels, office buildings and exhibition centres. The development of land, investment in second hand real estate and operation of real estate brokerage agencies was upgraded to the permitted category. Importantly, FIEs are free to set up non-bank financial institutions and operate e-commerce platforms independent from a local partner. In basic and value-added telecommunications services, FIEs may seek ownership shares of 50% and 49% respectively.

Even though the new version of the *Catalogue* is a marked improvement on past versions, its arrival has not been met with great excitement. Although welcoming the new revisions, the European Chamber of Commerce still criticised the *Catalogue* calling it

> "*only a small step for the Chinese Government's own stated ambitions of giving full play to the market*" (EUCCC 2014b).

The American Chamber of Commerce likewise welcomed the changes but immediately called for even bigger steps to be taken in order to promote freer trade (AmCham China 2015):

> *"While being a promising first step in the direction of a freer market in China, the Catalogue still discriminates against foreign businesses, thus making the Chinese economy a planned economy, not one based on a free priced system. Restricting which industries foreign companies may enter and subjecting them to different rules than domestic companies is blatantly protectionist and does not qualify the country as a market economy."*

Chapter 5.2: Outward Foreign Direct Investment

As early as 1999, the Chinese government introduced the “Going out” strategy to complement the earlier “Leading in” approach to investment inflows. The Going Out strategy has by now been fleshed out by a large number of detailed guidelines and administrative measures. The evolution of a regulatory framework combined with the strategy’s introduction in numerous government plans and programmes. A review of the FYP of provinces, autonomous regions and municipalities under the direct administration of the central government showed that all regions, with very few exceptions, promoted the Going Out strategy since the 11^{th} planning period. The initiative has been positioned as an integral part of the Chinese economic development model and is frequently referenced in industrial policy guidelines.

The Report illustrates the governmental instrumentalization (and promotion) of outward foreign direct investment activities by Chinese firms for the reduction of industrial overcapacitities in the domestic Chinese economy.

Chapter 6: Exchange Rate Regime

The Report discusses the institutional set up and working principles of China’s currency link-up to the global currency system. It analyses the exchange rate determination mechanisms in the Chinese “managed float” regime and the leeway existing for governmental interference. **The Report concludes its investigation with the assessment that in its present state the Chinese exchange rate system is neither designed nor able to transmit correct signals about respective competitive strengths between China and the global market place. As these signals are distorted, the welfare creating function of a global division of labour and highly diversified international value chains is seriously inhibited.**

Part III: China’s impact on the global economic system

Chapter 7: Does China meet the EU’s criteria to be considered a Market Economy?

In order to attain “market economy status” and become eligible for corresponding treatment in trade disputes, economies must concurrently fulfil all of the following five criteria (European Commission 2012):

1. Low degree of government influence over the allocation of resources and decisions of enterprises, whether directly or indirectly (e.g. public bodies), for example through the use of state-fixed prices, or discrimination in the tax, trade or currency regimes.

2. Absence of state-induced distortions in the operation of enterprises linked to privatisation (i.e. “carry over” from the old system). Absence of use of non-market trading or compensation systems (such as barter trade).
3. Existence and implementation of a transparent and non-discriminatory company law which ensures adequate corporate governance (application of international accounting standards, protection of shareholders, public availability of accurate company information).
4. Existence and implementation of a coherent, effective and transparent set of laws which ensure the respect of property rights and the operation of a functioning bankruptcy regime.
5. Existence of a genuine financial sector which operates independently from the State and which, in law and practice, is subject to sufficient guarantee provisions and adequate supervision.

In an appraisal conducted in 2008 EC staff concluded that criterion 2 should be assessed as having been met, while all other four criteria were not fulfilled by China. Summarizing China’s compliance, or non-compliance, with the EU’s five MES-criteria, the Report shows that today’s Chinese economic system is still far from fulfilling the remaining four of the five criteria:

- Chinese government continues to wield substantial influence over the allocation of resources and the behaviour of individual economic entities thereby relegating markets into a secondary role (criterion 1).

- Chinese companies are embedded in close-meshed networks with representatives of Chinese government as well as the CPC. These connections prevail over and distort the existing OECD-style legal framework and result in non-market conforming corporate governance, accounting and transparency practices (criterion 3).

- The Chinese laws for the protection of (intellectual) property rights as well as its bankruptcy regime are not yet fully functional. As such “market” outcomes remain distorted and discriminate against economic subjects relying on the principles of fair competition (criterion 4).

- The Chinese financial sector does not operate independently from government, but must comply with government directives for capital allocation. The price of capital neither reflects its true scarcity nor the varying degrees of risk involved in different transactions (criterion 5).

The present Chinese economic system might be highly capital intensive in character, but its institutional set-up and ordering mechanisms do not comply with the principles present in competition based markets.

Furthermore, it also has be highlighted that **a refusal by the EU to grant MES-status to China based on China's non-fulfilment of the criteria outlined above, must not be misinterpreted as a protectionist measure on behalf of the EU. On the contrary, the welfare creating effects of a highly fragmented global value chain – in which China should, and can, play an important role – can only come into existence if the best entrepreneurial ideas and most competitive enterprises are selected through the functioning of fair competition. Underperforming enterprises that are allowed to remain players in the global value chain due to political protection and irregular cost structures harm global welfare and retard economic development and progress in all participating societies in all parts of the global economy.**

The use of true market-determined external prices for determining whether there is dumping from non market economies is the only way to calculate the true measure of dumping and to prevent the distortions in the Chinese system from contaminating market based price setting in market economies. Any other approach will harm EU industries and discriminate against enterprises and economies complying with the principles of fair competition-based market processes worldwide.

Chapter 8: Impact of China on the global market

This study has amply documented the institutional set-up and working principles of the Chinese politico-economic system. **The evidence shows that the Chinese economy does not have the minimum requirements necessary for a competition-based market economy as understood in OECD terms. Nor does China meet the hands-on MES criteria catalogue of the WTO and EU.**

While China is free to choose the form of an economy that best suits its domestic situation, problems arise when it engages in international economic exchanges involving economic actors operating in different market contexts. Normal economic ordering regimes are always based on a set of signals and incentives that, in equilibrium, are designed to coordinate the interaction of the most number of factors. If one economy does not comply with the normal signals and incentives distortions appear in every economy touched by it. The functionality of national economic systems is impaired and contemporary welfare as well as dynamic development impulses are lost.

In order to allow incompatible individual markets to continue to function in their own spheres, institutional air-locks or buffers must be established that neutralise or contain the alien economic signals and keep normal signalling intact.

China has been committed to the erection of such institutional air-locks between its domestic economy and the global market place since it started to re-engage into the global division of labour in the late 1970s. Specialized trading companies with monopolistic powers, import and export cartels, trade quota systems, bonded export and foreign investment zones, foreign investment catalogues, licensing systems for inward and outward bound investment activities, strict foreign exchange administration, current and capital account currency convertibility restrictions, a managed (multiple) exchange rate system etc. all constitute such air-locks with which the Chinese government has been trying to shield the domestic economy from unwanted external impulses.

This chapter of the Report – inter alia – analyses the efforts made by market economies to prevent the distortions from the China economic model from injuring market economies. In 2013 alone, 75 anti-dumping measures were introduced by different countries. In the first six months of 2014, China accounted for 45% of worldwide anti-subsidy cases.

The Report illustrates various transmission channels by which European firms become exposed to unfair competition from Chinese firms receiving governmental protection and operating in crony-capitalist structures.

Chapter 9: Concluding analysis

The Report concludes with an overview of the major insights derived in the run of the analysis. **It comes to the final assessment that the Chinese economic system must be understood and classified as a state controlled market system that is distorting the global markets, thereby inhibiting their welfare creating function.** It finds that:

> *The study has beern able to identify a substantial number of mechanisms by which Chinese government interferes in the transmission of signals on economic strengths and competitiveness and also intervenes directly in the composition and intensity of cross border activities. Ranging from distortions of the exchange rate to explicit subsidies to preferential tax arrangements these governmental interventions distort the sectoral pattern and product specific structure as well as absolute intensity of China's integration in the global division of labour. As a consequence, the role Chinese firms play in product specific global value chains are not compatible with any comparative advantages in China or and the individual firms' true competitive strengths. While this allows Chinese firms to gain unsustifiably large market shares and corresponding revenue income, other, actually more competitive firms are being crowded out and must leave the market.*

As a consequence the Study comes to the conclusion that

> *the classification of China as a non-market economy constitutes a necessary "air-lock" mechanism shielding the European market system from alien, distorting influences. Only by withholding MES privileges and upholding the third-country-comparison methodology facilitated by treating China as a non-market economy can the real scope of price distortions in China's factor of production and goods markets be reveiled and true level of dumping be calculated. Any other approach will harm EU industries and discriminate against firms and economies upholding the principles of fair competition-based market processes worldwide.*

Only by guaranteeing a fair competitive process that selects the best players for participation in the global value chain and weeds out those which are profiting from irregular practices, can welfare be created on an equitable and sustainable basis – for all societies participating – and dynamic economic development on a global scale be promoted.