A PRAGMATIC APPROACH TO CHINA MES:
WAIT FOR THE WTO TO DECIDE
Why "mitigating options" don't work, the risks of a unilateral interpretation of the Protocol and the key pillars of an effective anti-dumping system

Executive Summary

China is not a market economy according to EU law. And there is no indication that it will suddenly become a market economy any time soon.[1]

The WTO has general rules to allow members to address unfair trade. Special rules are needed to calculate dumping margins of imports from non-market economies because costs and prices in a non-market economy are distorted by government interference. Under Section 9 of its WTO Accession Protocol China made the general commitment to allow all prices "to be determined by market forces". It has not honoured that commitment. If it had, then there would be no need for special dumping calculation rules for imports from China.

The debate on interpretation of the Protocol is whether these special rules can continue to apply to China after December 2016, once subparagraph 15(a)(ii) will have expired, even if China has not become a market economy and prices continue to be distorted by government interference. How should the remaining provisions of Section 15 be interpreted? And should importing WTO members not interpret the Protocol the same since the Protocol language is the same for all?

As China's Protocol of Accession is a WTO document, the WTO is the only organisation competent to give a global and definitive interpretation of the Protocol. Until the WTO establishes an agreed interpretation, no WTO member can be sure that its own interpretation of one part of the Protocol is correct.

Despite that, some in the European Commission seem keen to press ahead with a unilateral interpretation of the Protocol and propose that China be considered a market economy. In practice, this would translate into amendments to the Basic EU Anti-dumping Regulation to mandate the use of Chinese prices and costs as the basis for determining the "normal value" for purposes of the calculation of dumping margins.

[1] In August 2015, DG Trade commented on China's lack of progress as follows: *As regards China, since 2008 no consultations on MES have taken place. In 2014, the Commission remained willing to discuss further progress made by China towards MES, expecting that the Chinese authorities would continue to engage in the exercise and deliver the necessary information for the MES analysis by the Commission (*see REPORT FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT - 33rd Annual Report from the Commission to the Council and the European Parliament on the EU's Anti-Dumping, Anti-Subsidy and Safeguard activities (2014), p. 6.)

Although the Commission has not disclosed its intentions on how to deal with China in anti-dumping proceedings after 2016, there are reports of reflections on some sort of "compromise" which would try to balance the expectations of China with the need to maintain an effective anti-dumping instrument.

This paper explains that any changes to the EU's trade defence instruments that the Commission might propose with the aim of mitigating the negative effects of a premature and unilateral decision to grant MES to China - whether via "cost adjustments", the removal of the lesser duty rule, or others - simply would not be effective to avoid an irreversible weakening of the EU anti-dumping instrument in the face of dumped imports from China.

Further, the mere presentation of a Commission proposal that publicly says there is a WTO obligation to grant China MES in 2016 could have significant negative effects. Such a legislative proposal risks impairing the ability of the EP and Council to interpret the Protocol differently, and would weaken the position of international partners.

In fact, such a proposal would be in anticipation of the WTO's interpretation. What if the Commission's interpretation is wrong and the WTO reaches a different conclusion? As there is no clear legal obligation under WTO rules to grant China MES by 2016, there is nothing to prevent the EU from just waiting until the WTO decides. That is what the WTO dispute settlement framework is for: to provide an authoritative interpretation of WTO rules.

Why there are no effective "mitigating options" and compromise solutions will not work

Rather than just waiting for a WTO interpretation, some in the Commission seem intent on proposing the grant of market economy status to China, based on the idea that it would be possible to balance the expectations of China with the need to maintain an effective anti-dumping instrument.

Unfortunately, however, this is not possible. In fact, when determining the "normal value" (and therefore the dumping margin) in an anti-dumping procedure, the investigating authorities must use as the basis of calculation either the prices and costs of the exporting country producer (as WTO rules generally require) or "alternative methods" which make use of other prices and costs (as they are authorized to do with China pursuant to the provisions of China's WTO Accession Protocol). There is no middle ground.

Any attempt to move away from the possibility for the EU investigating authorities to regularly use non-Chinese prices and costs to calculate the "normal value" in anti-dumping investigations of imports from China, to the systemic use of Chinese prices and costs as the starting point, will be a

de facto grant of MES to China, because the result would be the ending of the use of the special rules for China before China achieves the goal of letting prices be determined by the market.

This is why the changes being discussed today are no more than a fig leaf. These possible changes will be examined in turn.

a) **"Cost adjustment"** to the Chinese producer costs to take into account distortions in the prices of the various inputs used to make the product concerned.

This "solution", already available under Article 2.3, 2.4 and 2.5 of the EU Basic Anti-dumping Regulation, and already used by the EU in some cases (e.g., to adjust "normal value" calculations for distortions in the Russian energy market) would be impractical in relation to China because:

(i) the cases to date which have made use of cost adjustments essentially concern the distortion of a number of identified and justifiably selected number of inputs, representing a significant percentage of the cost of production, while in the case of China, distortions concern a multiplicity of inputs and are multiple in nature;

(ii) the burden of proving the existence of such distortions is in the hands of the complainants, meaning additional costs for businesses injured by dumping, made all the more difficult in the case of China by an opaque system with distortions at multiple levels;

(iii) the EU's use of cost adjustment is currently under challenge by several countries at the WTO **and, as anticipated by a recent MLex report on the WTO decision in the *Argentina – Biodiesel* case, the EU methodology appears to be in potential contravention of the EU's WTO obligations** (the provisional WTO panel report on this case is understood to have been provided to DG Trade in early December 2015).

Finally, cost adjustments are already a possibility for cases where Chinese producers obtain Market Economy Treatment, but that has not prevented those producers from obtaining very low duty margins.

b) **Removal of the "lesser duty rule"** which requires that duties not exceed the level of the injury suffered by EU producers, in cases where that is lower than the dumping margin

Even apart from the major political challenge (the waiver of this rule would have to be applied *erga omnes* and not just vis-à-vis China, and many EU countries opposed this change, to the point of blocking the proposal for TDI modernization), this "solution" would have no impact on the level of the duties because the use of Chinese prices and costs would result in dumping margins well below the level of injury.

c) **"Sectoral" (and / or "grandfathering") solution** which could take one of several forms. For example, the Commission could envisage a concession of MES to individual "sectors", excluding some or all of the industries currently covered by AD measures (a "grandfathering" of sorts which would constitute in this case a sort of sectoral solution). This "solution" would not avoid a WTO

challenge by China; would offer only limited protection over time (and perhaps limited only to certain sectors); and above all would effectively close off use of the instrument for industries not currently covered by measures.

Another form of "sectoral solution" would simply be to identify upfront sectors for which cost adjustments are known to be necessary, in order to facilitate the use of the cost adjustment option for certain sectors. In this sense, the "sectoral solution" would be a variant of the "cost adjustment" "solution". This approach would not prevent a WTO challenge on pan-sectoral Chinese cost adjustments (as the EU is facing now from other countries). More fundamentally, the cost adjustment "solution", whether applied by sector or not, has all the weaknesses identified above.

To the extent "grandfathering" is understood simply as not applying the change in methodology to cases initiated before December 2016, that is in any event the standard way a change would be applied under the WTO rules. It would not represent any "favour" to EU industry.

To the extent "grandfathering" is also understood to mean the Commission would not consider interim review requests of any measures already in place on 11 December 2016, "grandfathering" would be of limited effect (assuming it would only hold until the normal expiration date of those measures) and would in any event be open to WTO challenge by China as denying its right to interim reviews following a change in circumstances. Furthermore, this risks seriously hampering investments: the amount of capital required to keep the pace with innovation might not be justified if the EU market is expected to operate under fair competitive conditions only for a limited number of years.

d) **Reliance on the anti-subsidy instrument**

For a number of reasons, it is unrealistic to expect that the anti-subsidy instrument would "fill the gap" left by the ineffectiveness of anti-dumping measures following a grant of MES to China.

To begin with, the subsidies agreement was drafted to deal with conditions in a market economy and is ill-suited to deal with the economy-wide and fundamental distortions inherent in a planned economy like China’s. Prices for key industrial inputs and end products in China's economy are shaped by government policy, are very low, and take no account of market conditions. An artificially low price, as such, is not a subsidy whereas under the AD Agreement, it is an unfair market distortion which is addressed by making reference to the full costs of production.

As a general matter, the WTO anti-subsidy instrument is complicated and difficult to apply. Firstly, one has to show a contribution by the state which confers a quantifiable economic benefit on the recipient; secondly the subsidy has to be shown to be specific (i.e. not generally available); and thirdly, even if these two tests are passed, the amount of any subsidy has to be allocated over the total sales of the company, and for some subsidies over years, which drastically dilutes the remedy that can be applied.

In practice, many distortions in China are not addressed by WTO anti-subsidy rules. In China, the Party identifies and heavily promotes important industry sectors by its 5-Year Plans. These plans are not based on market demand and lead to substantial excess production that China does not need and which is then dumped on world markets. Competition in the Chinese domestic economy is also heavily restricted via both low non-market pricing, which makes selling there unattractive, and via more direct barriers.

In addition, and not least, the opening of an anti-subsidy investigation depends on evidence from publicly available sources, but in China the system is opaque with little made public. In this respect, China is in clear breach of its WTO obligations as it has refused to provide an acceptable or believable listing of its subsidies. In addition, the government of China has never cooperated in an EU anti-subsidy investigation. Thus, it has been impossible to prove the full extent to which Chinese producers are receiving illegitimate and distortive subsidies. China should not be allowed to choose to apply only those WTO provisions which are to its advantage.

Given the opaque system and multiplicity of benefits in China that are not always quantifiable but are often generally available, the challenges of countervailing imports from China make it unrealistic to think that anti-subsidy measures could be effective to address dumped imports. This is borne out in the level of measures resulting from EU anti-subsidy investigations of imports from China. Indeed, nearly half of those investigations have been closed without the imposition of measures, and the average rate of anti-subsidy duty has been 6.4%. Duty rates around 6% or less are clearly inadequate to deal with Chinese distortions, as they are absorbed by Chinese exporters who do not have to worry about the effect of low pricing on profitability.

e) **Otherwise strengthening the anti-dumping and/or anti-subsidy instruments**

The most obvious option for strengthening the anti-dumping and anti-subsidy instruments is the removal of the lesser duty rule. However, if the EU grants MES to China, the level of measures will almost certainly be always below the injury margin, meaning that the removal of the lesser duty rule would have no practical effect.

Beyond the removal of the lesser duty rule, there is little that can be done within the restrictions of the WTO agreements, in particular as there is a general obligation not to discriminate against imports from a particular Member, whether China or anyone else.

None of these possible "mitigating options" would therefore be a satisfactory solution to preserve the effectiveness of the anti-dumping instrument.

The key pillars of an effective EU anti-dumping system

It is therefore worth identifying the key pillars of an effective EU anti-dumping system.

- Until China delivers on its Protocol commitment to allow all prices to be determined by market forces, prices and costs in China cannot be used as the starting point to determine the "normal value" (except when Chinese manufacturers can clearly demonstrate that market conditions prevail for them, with reference to the existing five criteria, which represent the only existing parameters to encourage China to continue on the path of reform).

- There can be no reversal of the burden of proof, which must remain in the hands of Chinese producers. It must not be required of complainants, the European producers, to prove that market conditions do not prevail in a given industry or sector. The Protocol does not require it and the opacity of the Chinese system would make it an unreasonable burden.

- The EU needs to coordinate its moves with key international partners, especially the US, to avoid distortions of trade flows and any impact on the TTIP negotiations.

- In any event, before the EU can grant China MES, China needs to demonstrate that it meets the five EU criteria. There is no "automaticity" with regard to the granting of Market Economy Status to China in December 2016.

The systemic risks of a legislative proposal based on a unilateral interpretation of the Protocol

It should be underlined that even the simple presentation of a legislative proposal that would significantly limit the possibility of regularly making use of "alternative methods" to calculate the "normal value" in relation to China, and would require the use of Chinese prices and costs, could have significant negative consequences.

In fact, such a proposal could only be based on an interpretation China's WTO Protocol of Accession that considers that the removal of sub-paragraph 15(a)(ii) "automatically" obliges the EU to grant China MES.

This in itself would have consequences even before, and independently from, consideration of the proposal by the European Parliament and the Council. Such a legislative proposal might impair the ability of the EP and Council to interpret differently the text of the Protocol: the Commission could appeal to the fact that, in the event of a WTO dispute, the Commission would fix the line of defence and that therefore the other institutions should not interfere.

Furthermore, the Commission's public position would weaken the position of international partners, including the United States, who wish to take a different position in the case of a very likely dispute at the WTO (the interpretation of the Protocol by the Commission, which represents the EU at the WTO, would inevitably influence any subsequent dispute on this point).

The fear of retaliation

It is clear that there is no need to act unilaterally and that any adjustments to the general trade defence instruments cannot compensate for the radical change being proposed.

Furthermore, the changes to the fair trade rules that might be considered to try to mitigate the effects of granting MES are not meaningful changes at all. They just rely on existing rules that are already available.

What may be driving those who wish to make a policy proposal in favour of China might therefore be a fear of retaliation, retaliation that has not even been publicly examined or quantified.

However, if China considers it has a right to MES under its Accession Protocol, it can request WTO consultations and ultimately bring an action before the WTO. It is probable that it will have to do this anyway as countries such as the US and Canada indicate that they see no obligation to grant MES to China in 2016. In any event, as there is no clear legal obligation under the WTO rules to grant China MES by 2016, the fear of retaliation essentially boils down to a fear of arbitrary and illegal bullying. Given China's reliance on exports to the EU, not to mention domestic investments by EU sources, it would appear that China – which needs the EU market as well – would have more to lose by engaging in illegal bullying than it would have to gain.

What would happen if the Commission decides to delay a decision on this matter

It is important to clarify that even a future adverse WTO decision, in the event the EU had not granted MES and was later found obliged to do so, would not result in any retroactive financial liability for the EU. There can be no retrospective financial responsibility for the EU under WTO rules, even if a report of the Dispute Settlement Body (panel or Appellate Body) ultimately finds that the EU has acted, or is acting, in violation of its WTO obligations. The obligation to comply is prospective and even then, the violating Member has a "reasonable time" in which to bring its legislation and practices into compliance.

Under EU law, there would also be no basis for a claim for the retroactive refund of duties, and that conclusion follows primarily from the reasoning in the EU Court of Justice in the *Rusal Armenal* decision and the fact that the EU legislator never made any attempt to incorporate the provisions of China's WTO Accession Protocol into its anti-dumping legislation:

- While the WTO anti-dumping rules can be given direct effect in the EU (as the ECJ said in the *Nakajima* decision), there is a specific ruling of the Court that this is not the case with the NME (non-market economy) provisions of Article 2(7).

- Specifically with regard to China, the EU legislator never incorporated the provisions of Section 15 into its anti-dumping legislation, nor otherwise indicated an intent to make those provisions directly applicable in the EU legal order.

- Therefore, the measures established in conformity with Article 2(7) before any WTO decision saying the EU had violated its WTO obligations could not be challenged on the grounds that they were not WTO-compatible (and therefore require a refund of duties).

- To be complete, decisions of the WTO DSB are not given direct effect in the EU legal order. This has been established by a number of ECJ decisions. Therefore, the decision of the WTO DSB would itself also not be a basis for a refund claim in relation to EU anti-dumping duties paid prior to the WTO decision.

Conclusions

China considers that Section of 15 of its Protocol of Accession to the WTO automatically entitles it to be considered a market economy for anti-dumping purposes as from December 2016. Many legal analysts, the European business community, EU Trade Unions, large sections of the European Parliament, several EU Member States, and third country Governments disagree.

One thing all do agree is that subparagraph (a)(ii) of Section 15 of the Protocol expires at midnight on 11 December 2016. They also agree that the rest of Section 15, including all other parts of paragraph (a), remains in force after that date. The problem is interpreting the impact of the expiry of one subparagraph when the rest of the text remains the same and in force.

Rather than anticipating the WTO interpretation applicable to all WTO Members, the European Commission should adopt a completely different approach. The Commission should not aim at proposing a "solution" based on a one-sided and unilateral interpretation of the remaining provisions of Section 15. This is particularly so as all, both lawyers and policy makers, agree that the WTO will have to come up with the definitive interpretation at some stage.

In fact, a long-lasting “solution” will only exist once the WTO will have interpreted the remaining provisions of Section 15 of China’s Accession Protocol to the WTO, clearing up the ambiguity present in the text and clarifying whether and to what extent importing countries can continue to use “alternative methods” to calculate the “normal value” in the context of anti-dumping proceedings against imports from China. Only then it will be possible to find a consensus on a compelling and WTO-consistent legal-technical solution to deal with dumped imports from China.

Meanwhile, Chinese producers involved anti-dumping investigation will maintain the possibility to file requests for Market Economy Treatment (MET), and they operate according to market economy rules, they will be granted a lower duty and they will not be affected.