



Ending China's differential treatment

What's at stake for EU trade defence?

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- When China joined the WTO in 2001, its accession protocol included an option for members to apply alternative methodologies when assessing dumping for Chinese imports. This reflected China's special status as an economy in transition. The EU has made use of this option, normally using an alternative methodology to calculate dumping in cases involving China. WTO rules allow for special treatment in anti-dumping (AD) investigations for so-called non-market economies on grounds that prices do not really reflect market forces and EU legislation. Typically, non-market economy treatment is associated with higher levels of protection for domestic industries.
- Parts of the provisions in the accession protocol are set to expire in December 2016. As a result, the future approach to determine dumping in investigations concerning China in the EU has come under debate – as well as the potential implications of any changes to the current treatment.
- From a European perspective, there are several options on the table: They range from sticking to the status quo, i.e. continuing to provide for differential treatment, to allowing for full market economy treatment – a potential game changer for Chinese exporters in AD investigations.
- The outcome matters for both European and Chinese industries and could have potential ramifications on China-EU trade relations. First, China is the largest source of imports for the EU with a share of 20% of extra-EU imports and the exporting country most frequently concerned by the EU's AD activity. European industries will be affected to a varying extent depending on whether they are downstream users, export-oriented or import competing. Steel and ceramics might be particularly sensitive in the latter category. Second, the debate will give an indication of the perceived degree of state influence in the setting of prices and costs in the Chinese economy. Third, the EU's ruling could be indicative of the direction of the EU-China bilateral investment treaty, which is currently being negotiated.
- The European Commission has to walk a tightrope taking into account the concerns of the different market participants affected as well as member states, which have often held divergent positions on AD in the past. Balancing the different views is not going to be easy but important for the EU to ensure future trade defence rules and practices concerning China will be sound and robust.



Ending China's differential treatment

Anti-dumping in brief

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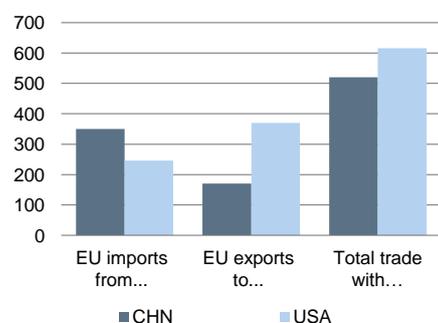
- WTO rules (on the basis of GATT Art.6 and the Anti-dumping agreement) allow members to take action against dumping. Extra import-duties can be charged on the particular product from the particular exporting country.
- AD measures are imposed following an investigation to determine whether dumping takes place and to what extent this causes injury to domestic producers.
- AD duties are temporary protection. In the EU definitive duties can last until 5 years.
- AD forms part of WTO's contingent protection instruments also incl. countervailing duties and safeguards.
- In the academic literature, AD plays an important role to ensure a level playing field and some flexibility in global trade (see Hoekman/Kostecki 2001 for an introduction, and Milner/Rosendorff 2001 on flexibility).

Sources: WTO, European Commission, Deutsche Bank Research

The EU's two top trading partners

2

Merchandise trade volumes for 2015 in EUR m

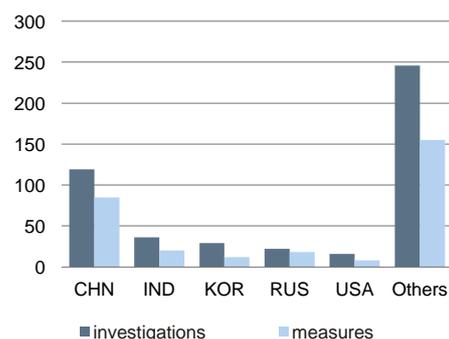


Sources: European Commission, Deutsche Bank Research

EU anti-dumping activity

3

Number of investigations and measures 1995-2014, EU (reporting) vs exporting countries



Sources: WTO, Deutsche Bank Research

Accommodating a special member: China's WTO accession and anti-dumping arrangements

It is a fifteen year old arrangement that is now causing stir: When China joined the WTO in 2001, its accession protocol allowed members to apply an alternative methodology to calculate dumping margins for Chinese imports.¹ This was always meant to be a transitional arrangement. With parts of the provisions set to expire on 11 December 2016, the implications of any change to the status quo have become the subject of a controversial debate in the EU.

WTO rules allow members to impose anti-dumping (AD) duties on products from third countries if an investigation shows that products are dumped, i.e. sold at prices that are unfairly low, thereby hurting domestic industries.² Price comparison is essential to determine dumping. In the standard case, dumping is calculated by comparing the export price of a product to its domestic price or cost in the exporting country. However, if prices and production costs in the exporter's home market are not determined by market forces, the importing country investigating alleged dumping can use surrogates, drawing on data from 'analogue' countries as a basis for calculation. This is what is referred to as non-market economy (NME) methodology and what has been applied by the EU in AD proceedings concerning China. NME treatment is often associated with higher anti-dumping duties and greater protection from imports.

In determining dumping, the EU relies on its own legislation,³ which in turn allows using different methodologies. Up until now, this practice has been compatible with international trade law in the case of China. With part of the accession protocol expiring, the EU is currently assessing to what extent current AD rules need to be adapted and what would be the potential effects.⁴ The issue is both politically and economically sensitive as the EU aims to find a solution that is compatible with international trade law, taking into account China's significance as a trading partner as well as implications for European industries.

Anti-dumping and China from a European perspective

China is the largest source of imports for the EU with a share of about 20% of total extra-EU imports as of 2015. It is also the exporting country most frequently concerned by the EU's AD activity with a total of 119 investigations and 85 measures from 1995 to 2014, i.e. about 25% of total initiations and 29% of EU measures respectively.⁵ For comparison, the EU's second largest source of imports, i.e. the US with an import share of about 14%⁶, was subject to 16 AD investigations and 8 measures during the same period.

As of end 2015, imports from China were subject to 52 definitive AD measures. The share of EU imports from China covered by AD measures appears moderate – about 1.4% in terms of value according to European Commission

¹ See Art.15 on price comparability in determining subsidies and dumping of the accession protocol. While paragraph a) states that WTO members may use an alternative methodology provided that Chinese producers can not clearly show that market conditions prevail, paragraph d) declares that a) shall expire 15 years after accession.

² For the WTO's definition of dumping see https://www.wto.org/english/thewto_e/whatis_e/tif_e/agrm8_e.htm

³ See Council regulation (EC) No 1225/2009.

⁴ European Commission (2016).

⁵ Source: WTO statistics on anti-dumping available at www.wto.org

⁶ Values based on merchandise trade volumes with EU-28 for 2015. Shares excluding intra-EU trade. Source: European Commission, DG Trade.

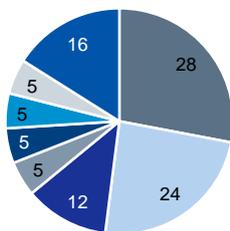


Ending China's differential treatment

Employment in sectors with products subject to AD measures concerning China

4

Percentage shares, end of 2015



■ IT ■ DE ■ ES ■ FR ■ PL ■ PT ■ FR ■ Others

Shares refer to the geographical distribution of employment estimated in sectors where measures concerning Chinese imports have been imposed.

Source: European Commission 2016a

Market Economy Status for China: Looking beyond the EU

5

While WTO rules provide for differential treatment for NMEs and market economies, they do not define exactly how to treat economies in transition. WTO member states can define ME status in domestic law including the procedures to get ME status.

Recognizing trading partners as MEs is left to WTO member states' discretion. Some have formal recognition procedures for granting ME status; this is the situation in the EU. In other countries, recognition can take place via political declaration.

Some trading partners have granted ME status to China during recent years (incl. Brazil, Australia, New Zealand and South Africa) – either via political decisions or formally – and often linked to negotiations of further trade agreements. At the same time, other large trading partners such as Japan, Mexico, India, and the US have not (yet) done so.

Sources: Barone (2015), Puccio (2015), Deutsche Bank Research

estimates.⁷ The sectors with the highest number of measures in force are chemical and allied (14) and iron and steel (13). Imports from China of products under measures are largest for electronics (EUR 2.1 bn), ceramics (EUR 673 m) and other mechanical engineering (EUR 442 m). As a share of imports from China subject to measures, ceramics stand out with almost half (47%) of imports covered, followed by textiles and allied (13%). In terms of employment, about 250.000 jobs in the EU relate to products on which AD measures are in force. About 90% (234.300) of these relate to products on which measures imposed concern imports from China. In terms of the sectoral distribution, most of these jobs are in ceramics, iron and steel, other mechanical engineering and electronics (solar). By geographical distribution, employment in sectors with products subject to AD measures is highest in Italy, Germany, Spain, France, Poland and Portugal.⁸

The share of trade (currently) covered does not fully reflect the significance of AD as a trade policy instrument, though.⁹ Measures imposed are likely to dampen import flows. Also, AD use can affect trade flows even if final measures have not been imposed yet, for instance due to uncertainty for exporters in an ongoing investigation. In addition, even without an ongoing investigation firms may anticipate potential new investigations as well as the possibility and extent of new duties, and adjust their export strategies accordingly. The rules that are being applied shape this calculus. Arguably, under market economy methodology, the threshold to impose new duties would likely be higher and even for cases where dumping is established, the duties would likely be lower. Thus, the end of non-market economy treatment would be good news for Chinese exporters but raise pressure for EU-import competing industries.¹⁰

Market economy status for China: From past assessments ...

Companies in non-market economies can request market economy treatment to be used in individual cases – but the 'burden of proof' is on exporters who need to show that market economy conditions apply. This is why a number of countries for which alternative methodologies are typically used, have applied for economy-wide market economy status, namely Armenia, Mongolia, Vietnam, Kazakhstan, Belarus – and China.

The EU grants market economy status after an in-depth assessment provided that it considers five conditions to be met. Criteria for assessment are

1. A low degree of government influence for allocation of resources and decisions of enterprises
2. Absence of distortion in the operation of the privatised economy
3. Effective implementation of company law including adequate corporate governance rules
4. Effective legal framework for the conduct of business and proper functioning of a free-market economy (e.g. IP, bankruptcy law)
5. Existence of a financial sector operating independently from the state

⁷ This includes undertakings for solar panels.

⁸ See European Commission (2016a).

⁹ See for instance Zanardi and Vandebussche (2010) who find a dampening effect of AD law adoption on aggregate trade flows. On a systemic level, the rules that govern AD use matter with respect to the role of contingent protection to ensure compliance with trade rules and its function as a flexibility element in the global trading system.

¹⁰ For further analysis of the political economy of AD see Wruuck (2015).



Ending China's differential treatment

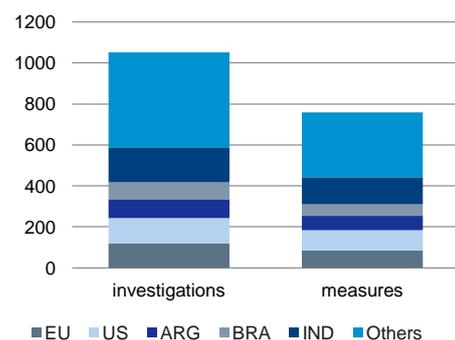
China requested market economy status as early as 2003 and has since been assessed several times. The last extensive analysis of 2008 acknowledged considerable progress on a range of conditions but concluded that economy-wide market conditions were not met.

... to the current discussion

Cases involving imports from China

6

Total AD activity by WTO members 1995-2014 involving China



Sources: WTO, Deutsche Bank Research

There are three different options on the table from the European perspective. These range from sticking to the status quo to allowing for full market economy treatment. A middle way would be to apply market economy treatment but add some qualifications. Each option comes with pros and cons:

1. *Stick with the status quo* – in this scenario differential treatment for China would remain. However, continued application of non-market economy methodology to China along the lines of current procedures risks non-compliance of European rules and practices on AD with international trade rules and raises potential for trade conflict. China could file a complaint using WTO dispute settlement and if non-compliance were established, ultimately resort to legal retaliation. In this case China could for instance restrict market access to certain EU exports to push for compliance and claim compensation.¹¹

China had made little use of the dispute settlement mechanism in the years following accession but this has changed in recent years: Since 2009, China filed 10 cases as main complainant. In particular it has challenged large trading partners like the US (six cases) and the EU (four cases). Anti-dumping has been the subject of a number of these disputes but – at least for the EU – complaints have tended to focus on specific measures that had been imposed and challenged rather than general methodology. Arguably, dispute settlement takes time and more often than not, solutions are found without actually resorting to retaliation. However, the conflict scenario would still imply costs in terms of uncertainty for business – Chinese and European – and risks to put a strain on EU-China trade relations.

2. *Change to full market economy treatment* – AD procedures would be adapted, removing China from the list of non-market economies and applying normal (market economy) methodology. Amending anti-dumping regulation to reflect the expiry of the transitional arrangement would require an ordinary legislative procedure.¹²

Switching to unconditional full market economy treatment would step up competitive pressure for some import-competing European industries. It is plausible to assume that the strongest impact would be felt in industries that have been granted AD protection frequently in the past and where China has become a key competitor. This includes industries such as metals, chemicals and solar.

The steel sector is a particular case in point here given its history with AD and current complaints about overcapacities and subsidisation schemes in China. The recently issued steel action plan by the European Commission laid down actions to make full use of trade defence measures, which includes initiating investigations based on the threat of injury.¹³

¹¹ See Art.22 of the WTO understanding on disputes.

¹² See European Commission (2016a).

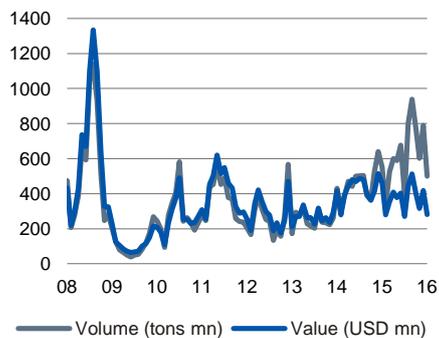
¹³ See European Commission (2016c). This option was already used in one of the AD investigations concerning steel products most recently launched in February, see http://europa.eu/rapid/press-release_IP-16-287_en.htm



Ending China's differential treatment

China's steel exports to selected EU members

7



Refers to exports of steel products to UK, France, Germany, Belgium, Italy and Netherlands.

Sources: China Customs, Deutsche Bank Research

Furthermore, the plan suggests steps to make use of trade defence more swiftly and decisively, urges adoption of the proposal to modernise trade defence instruments, and intends to put in place a prior surveillance system on steel products.

Overall, the broad set of relief measures, geared at sustaining jobs and promoting innovation, highlights the EU's sensitivity with regards to securing the competitiveness of steel and other energy-intensive sectors, and surging steel import volumes from China. In this context, the European Commission has been rather outspoken on China's obligation (under the WTO) to ensure transparency on subsidies, which points to an ongoing contentious debate. There is particular focus on the Commission's estimate of the size of China's overcapacities in the steel sector (350 million tonnes according to the report) as a gauge of future trade and pricing practices.

In addition, a number of European producers in other sectors might feel uncomfortable with the idea of switching to full market economy treatment because the AD's "deterrence" effect with regards to China would be smaller and they might see it as reducing their option to petition successfully for AD in the future.

Finally, against the backdrop of modest recovery but still high unemployment in many European member states and uncertainty regarding China's growth and policy outlook, the timing could prove particularly challenging.

3. *Introduce changes with qualifications* – it is possible to envisage a scenario in which market economy treatment would be applied for China but in combination with mitigating measures. These could be transition periods, for instance agreeing on a gradual phase-in of market economy treatment or grandfathering clauses for existing measures to limit the possibility for interim reviews. Other options could be sectoral exemptions to account for differences in market conditions across industries. A similar approach was applied to Russia after receiving market economy status in 2002 where domestic prices could be disregarded when "prices were not made in the ordinary course of trade or costs were not in accordance with generally accepted accounting principles", e.g. for magnesium metals.¹⁴ Also, ideas have included shifting the 'burden of proof' so that there might be an option to resort (back) to non-market economy methodologies but it would be for European producers to show that market conditions in a particular case do not prevail.¹⁵

In addition, alternative trade defence instruments such as countervailing duties or safeguards could be strengthened. Both are less frequently used compared to AD – in general and with regards to China.¹⁶

However, the precise design of any mitigating measures is crucial. Ideally, they should be objective, easy to administer, and effective in terms of ensuring a level playing field. In practice though, there may well be trade-offs. Sector-specific determination of market conditions may for instance be more fine-grained but come with greater costs of (re)assessment. A

¹⁴ Memorandum to Faryar Shirzad from Albert Hsu et al. (2002).

¹⁵ An exception in the form of market-economy treatment was introduced in 1998 in recognition of the changed economic conditions in Russia and China, which permitted use of normal values in cases where market economy conditions prevail for the investigated producer and product (Council Regulation (EC) No 905/98). However, no Chinese producer has been granted market-economy treatment in 2011-15. See European Commission (2015).

¹⁶ Out of 74 countervailing duty investigations 9 have concerned China and 35 (5) measures have been imposed. Source: WTO.



Ending China's differential treatment

reversed burden of proof might raise practical difficulties for European industries but also politicise the AD investigation process.

Finally, qualifications restricting market economy treatment may also run the risk of being incompatible with WTO rules, possibly being subject to legal challenges as well. Hence, these would require careful legal design as well as political balancing.¹⁷

What is going to matter in the debate?

The European Commission has started to analyse in greater detail the impact of the different options. Adapting current European AD legislation would be subject to ordinary legislative procedure, so there is likely to be intensive debate in the Council among member states and the European Parliament.

Against this backdrop, three aspects are going to be important:

1. Assessing the potential impact on European industries and economies

The potential impact of any changes to the status quo on European industries and employment are likely to weigh heavy in the debate. They warrant careful consideration all the more because estimates are highly sensitive to the assumptions.

Initial assessments have mainly concentrated on the case of full and unconditional removal of non market economy treatment and potential implications thereof. The underlying logic is that removing NME treatment for China would lead to a reduction in AD protection, lower prices for Chinese products and, thus, rising import pressure.¹⁸ A study commissioned by the European Commission for instance suggested that using market economy methodology could reduce the level of AD measures by 27 pp compared to application of the analogue country regime and that lower prices for products could lead to an increase in imports between 17-27% compared to the analogue country regime.¹⁹

In terms of industry effects, the usual logic applies, i.e. downstream users would benefit but import competing industries would face pressure. Partly, this would be due to measures expiring or being up for review in the near term. What makes mid-term estimations particularly challenging though is that they require assumptions about who might request AD protection against imports from China in the future – which arguably depends both on developments in Europe *and* China. Take for example the case of the European solar industry, which few might have considered to be in need of trade defence about a decade ago.

However, in the short-term, industries that are most likely to be affected are those that have benefited from AD protection relatively intensively in the past such as ceramics or steel. Both may prove particularly problematic. Steel has a history of fluctuating AD use, large overcapacities have built up in China, and it is one of the sectors where a potentially high number of jobs could be at stake. According to Commission estimates,²⁰ ceramics similarly stand out in terms of potential employment effects but also because jobs related to products covered

¹⁷ However, it should be noted that current AD legislation provide for the possibility to apply special rules laid down between the Community and third countries – but in practice, in order to withstand potential legal challenges these would need to be WTO compatible.

¹⁸ The reduction in protection is likely to reflect a mix of lower duties in some cases and no duties in others.

¹⁹ See European Commission (2016a).

²⁰ According to estimates, about 55.000 jobs in the iron and steel sector relate to products subject to AD measures concerning China. See European Commission 2016a.



Ending China's differential treatment

by AD are particularly concentrated in EMU countries still struggling with crisis repercussions and high unemployment, notably Italy, Spain and Portugal.

The size and geographical distribution of industries coupled with the domestic economic situation in member states are likely to affect the political debate. At the same time, industry effects also include potential benefits of cheaper imports for downstream using industries. Also, export-oriented European firms might assess these effects against the growing importance of trade relations with China.

2. China and EU are important trading partners

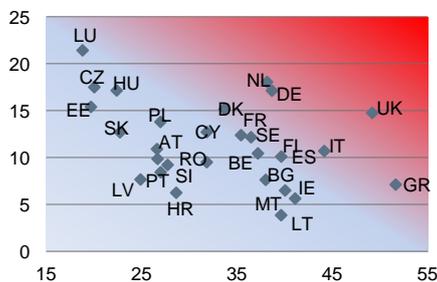
AD petitions are typically filed by firms – not EU member states. Firms petitioning for AD protection are located in different member states or have production facilities in multiple European countries (e.g. steelmaker ArcelorMittal). Also, “pan-European” cases, with a group of petitioning companies being located in different member states and represented by a European association, have become more frequent.²¹ At the same time, current EU rules require that AD measures are not implemented against the Community interest. To that extent, the approach with regards to AD treatment for China is an issue that concerns the EU in general and not only specific member states

Potential effects on import competing industries are likely to be a greater source of concern for economies with a high share of manufacturing industries competing with Chinese producers. Another point to consider is the importance of China as a trading partner for the different member states. Clearly, trade with China is more relevant for some than for others, depending i.a. on the proportion of intra-vs. extra-EU trade, China's share of extra EU trade for the respective country and the structure of bilateral trade flows.²² Greece or Malta for instance have relatively high shares of external trade – also reflecting geography and economic size – but their share of external trade with China is moderate, whereas a number of CEE-economies trade a lot with China but extra-EU trade in total is far less relevant. Based on the two trade shares only, the issue of NME might be particularly relevant for Italy, Netherlands, United Kingdom, Finland and Germany, i.e. countries with both relatively high external trade shares and close trade links with China. In addition, member states also differ with respect to their trade structure with China. While most import more than they export, for Finland and Germany in particular China is also a key destination for exports, suggesting importance of maintaining good trade relations. Beyond (bilateral) trade, a number of other issues may influence member states' stance towards China's future AD treatment, including different views on the use of contingent protection in general.

Trade intensity with China across member states

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X-axis: External (non-EU) trade, share of total trade
Y-axis: China share in external trade

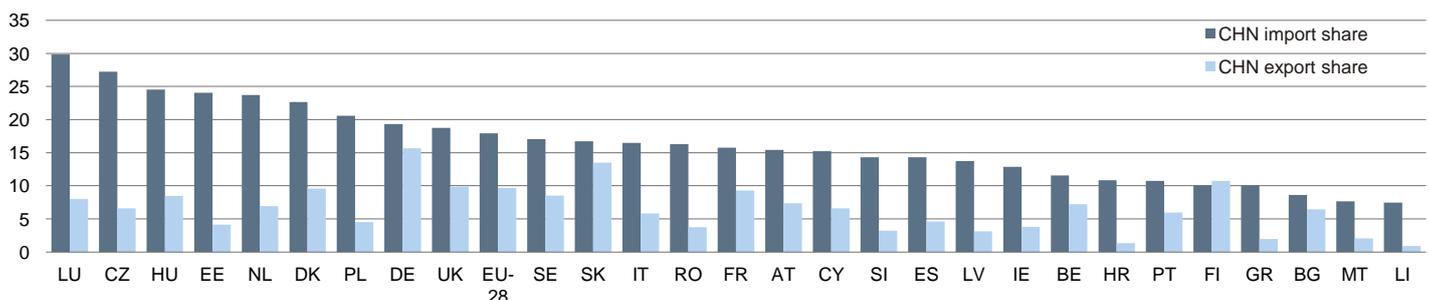


Sources: Eurostat, Deutsche Bank Research

China as a trading partner

9

Share of imports from/exports to China (percentage of extra-EU trade, 2014)



Sources: Eurostat, Deutsche Bank Research

²¹ Based on Bown (2015).

²² See also Hansakul and Levinger (2014).



Ending China's differential treatment

3. China's progress towards a market-based system has been bumpy

Finally, China's policy and reform decisions and European perceptions thereof are likely to affect the current debate and the options for China's future AD treatment. In the aftermath of the Commission's 2008 assessment of China's progress towards achieving market economy conditions,²³ reforms have continued on a number of relevant aspects. To be sure, not the functioning of China's economy or its general eligibility as a market-economy is at the centre of the EC's current assessment. Rather, the degree of (state) influence is gauged with a view to whether certain policies or mechanisms could skew conditions in favour of domestic companies and, thus, make Chinese prices and costs unreliable for their use in trade defence investigations. As a consequence, continued high levels of distortion may still warrant differential treatment.

To classify as a market economy from the EU's side, absence of such mechanisms has to be testified in line with the criteria listed above (see p.3). A planned review by the European Commission and negotiations with stakeholders this year do not change the expiry of China's NME-provision but could give a useful guidance on the expected treatment after December 2016.

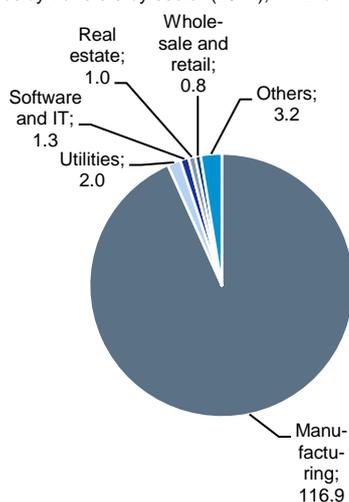
The table on page 9 provides a list of the progress and remaining bottlenecks specified by the EC in the 2008 review. In addition, it gives an overview over selected steps taken by China in recent years and related to the criteria that were highlighted in the report. Back then, China was attested significant achievements in all reform areas but several shortcomings prevailed. Altogether, 4 out of 5 criteria were considered unfulfilled.

Nearly eight years on, China has come a long way with fine-tuning and amending existing laws and streamlining procedures. Moreover, deregulation and simplification continued in several industries, and public projects have been opened further to private capital. But despite notable progress, few of the specified shortcomings appear to have been addressed in full and many of the distortions identified by the European Commission's 2008 report remain prevalent. Industrial policy is still broadly steered by sector-specific development targets and promotion of specific firms or sectors. Input prices for raw materials continue to be strictly controlled. Outright export subsidy programmes – a thorn in the side of WTO – have been gradually dismantled. However, in addition to official transfers subsidisation likely continues to be applied through indirect and local channels, which are more difficult to assess. Subsidies have overwhelmingly targeted the manufacturing sector but also followed policy programmes promoting specific firms or sectors, e.g. integrated circuits or rare earths.²⁴ Input subsidies or restrictions on exports and imports matter for trade defence investigations as they may impact domestic supply and demand and, hence, translate into lower domestic prices.

An example with particular relevance for AD is pricing reform, where the number of items subject to price restrictions was cut to 20 from nearly 100 in September 2015, and government-set price categories were slashed to 7 from 13.²⁵ In October 2015, China's State Council set a timetable for lifting price controls on goods and services in competitive sectors by 2017. But such price deregulation has targeted mostly domestically oriented sectors such as transport and services (e.g. parking and cap fees).

Subsidies overwhelmingly target manufacturing

Subsidy transfers by sector (2014), RMB bn



Sources: Think!Desk (2015) based on WIND Data

10

²³ European Commission (2008).

²⁴ Think!Desk and AEGIS Europe (2015).

²⁵ See State Council press release. Timetable for pricing reform unveiled. 15 Oct 2015.



Ending China's differential treatment

How China's market-economy criteria have evolved after the 2008 assessment

11

Criteria highlighted in 2008 assessment	Aspects where progress had been made in 2008	Aspects where shortcomings prevailed in 2008	Selected steps taken since last assessment*
1 Low degree of government influence for allocation of resources and decisions of enterprises			
Export obligations	General removal of export obligation policy by law, gradual liberalisation of trade and trade-related policies	Export restrictions including licensing and quotas	
Price fixing and utility rate setting		Price levels and industrial inputs still set and monitored by National Development and Reform Commission (NDRC) at national level, administered at local level	Price controls eased in sectors incl. pharmaceuticals, telecommunications and transport. Timetable unveiled for phasing out price controls on goods and services in competitive sectors by 2017, establishing sound pricing mechanism and transparent regulation
Taxation	Enterprise Income Tax Law of 2008 abolished all tax reductions and exemptions for exported products, introduced standard rates for foreign-invested and domestic enterprises	Prevalence of export taxes tends to distort domestic prices. VAT and excise tax may be rebated on exports of certain products.	Termination of corporate income tax deduction for export-oriented foreign invested enterprises and preferential treatment abolished for local firms in SEZs exporting >70% of output
Industrial policy goals distorting domestic competitive conditions	Five-year plans capture broad development objectives instead of line-by-line goals	Investment catalogue classifying industries into "encouraged", "restricted", "prohibited"; credit guidance to commercial banks, targeted subsidisation and priority lending e.g. as part of "going out" programme	Reduction of restricted items on foreign investment catalogue. "Famous brand" initiative, which included export-contingent subsidies, abandoned in 2009 following complaints by US and EU at the WTO. New draft foreign investment law issued in early 2015
Input subsidisation	Less direct price subsidisation for basic raw materials, announced basic reform of electricity transmission and distribution tariffs fixed by NDRC	Input costs tend to be distorted mostly due to upstream state subsidies. Competition distortion notably in steel sector	
2 Absence of distortion in the operation of the privatised economy			
	Criterion was considered as fulfilled in the earlier 2004 assessment		
3 Effective implementation of company law including adequate corporate governance rules			
Management of state assets and corporate governance	Suitable legal framework provided by new Company Law and refinement of Securities Law and Code of Corporate Governance for Listed Companies. Shareholding reform of 2003 and SOE corporate governance reform of 2004 support goal of operation autonomy	Prevalence of state influence in the decision-making process, e.g. through restrictions on granting of business licenses and over-representation of state shareholders on company boards	Self assessment conducted by China's CSRC jointly with OECD in 2011 set benchmark for improving corporate governance in listed companies
Accounting standards	Accounting law of 2007 covers nearly all necessary topics as set out in IFRS	Lack of efficient enforcement mechanisms at central and local levels	Roadmap for Continuing Convergence of Chinese Accounting Standards with IFRS released by China's MinFin in 2010, working group to advance use of IFRS within China set up in Nov 2015
4 Effective legal framework for the conduct of business and proper functioning of a free-market economy (e.g. IP, bankruptcy law)			
Property rights	Property Law of 2007 supported private ownership rights	Ambiguities over legal status of private assets that may affect access to credit, difficulties with respect to verifying land ownership	
Intellectual property rights	Efforts to align IPR laws with international standards	Lack of effective enforcement mechanisms, burdensome requirements and weak legal enforcement	Amended trademark law which took effect in 2014 streamlined registration procedures, clamps down on infringements and strengthens legal protection
Bankruptcy procedures	Bankruptcy Law implemented in 2007 mostly in line with standard international practice with some China-specific provisions and supportive measures to facilitate implementation	Exemption of 2000 worst-performing SOEs; enforcement impeded by early stage of implementation, i.e. low number of proceedings, low recovery of claims, limited alternatives	Completion of transition period but enforcement remains work in progress with many distressed companies kept afloat
Competition policy	Anti-Monopoly Law of 2008 inspired by EU experience in antitrust legislation and applied uniformly to domestic and foreign companies, including SOEs	Criteria for "national security" reviews of foreign M&A of domestic companies not defined, exemptions from anti-monopoly rules for some strategic goals such as technology, quality upgrades, SMEs and environment	Numerous changes since the Third Plenum, incl. commitment in 2014 to fair and equal treatment of foreign and domestic enterprises. State Council announced plans in September 2015 to review the Anti-Monopoly Law
5 Existence of a financial sector operating independently from the state			
Access to credit	Improving financing channels for private firms and SMEs, SME board established at Shenzhen Stock exchange, State Council and PBoC promulgated over 20 SOE regulations	Remaining constraints to access credit, in particular in absence of credit history; exchange of credit (cross) guarantees is common practice	New cross-border guarantees policy adopted in 2014. Targeted policies to support SME financing, loan rejection rate improved
Interest rates		Interest rates set by PBoC prevail in bank lending rates and do not properly reflect true costs of borrowing; fully binding deposit rate ceilings	Full interest rate liberalisations in 2015
Banking reform	Progress on reform of major banks following international best practices. Ongoing efforts to step up credit rating capacity of banks, lending and deposit-taking partially deregulated	Selective implementation of international standards, lack of independence of supervisory bodies and classification rules in favour of government-backed projects, delays in obtaining licensing and lending restrictions	Deposit insurance introduced in 2015; stepped-up regulation of shadow banking system; improved transparency through adoption of IMF's Special Data Dissemination Standards
Non-performing loans	Risk management within major banks improved	NPL figures exclude loans transferred to asset management companies or special-mention loans, absence of fully operational clearinghouse on credit histories hampers effective credit risk analysis on potential borrowers	
Role of policy banks	Government continues to play significant role in banking and financial sector, including targeted financing or selected sectors and firms	Introduction of partially foreign or private investment in state banks	Inception of new policy banks such as Asian Infrastructure Investment Bank (AIIB) with infrastructure focus

* List of selected measures taken after 2008 is not exhaustive and is based on anecdotal reform steps that are not fully reflective of the overall status quo of the respective criteria, thus cannot replace an in-depth assessment of the state of distortions in the economy.
Sources: European Commission (2008), Defever and Riano (2014), US-China Economic and Security Review Commission (2015), OECD (2011, 2015), IMF (2015), China State Council, media reports.

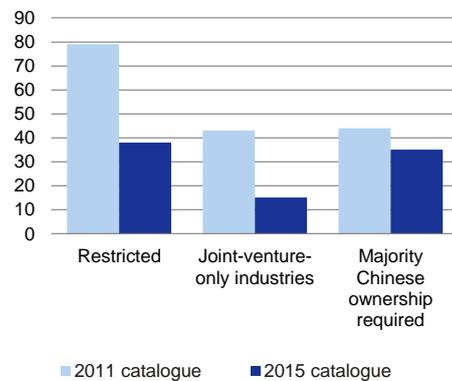


Ending China's differential treatment

Investment catalogue was relaxed but not abandoned

12

Number of industries classified as...



Sources: China Ministry of Commerce, US-China Economic and Security Review Commission (2015)

Policy objectives continue to steer investment, where target industries are classified into “encouraged”, “restricted” and “prohibited”. Again, recordable progress has been made, with the number of “restricted” industries reduced by 41 between the 2011 and 2015 catalogue, and the number of “joint-venture only” sectors cut by 28.²⁶ On the flipside, some sectors saw heightened restrictions, including automobiles, healthcare and education. Foreign investment in legal services moved from restricted to prohibited in the 2015 catalogue, despite commitment to open up the legal services industry following WTO accession.²⁷ The underlying legal framework is still evolving and a draft Foreign Investment Law that would bundle up existing legislations was circulated by the Ministry of Commerce in early 2015. One of the key merits would be a replacement of the catalogue with a negative list approach, where investment is only prohibited when explicitly ruled out.

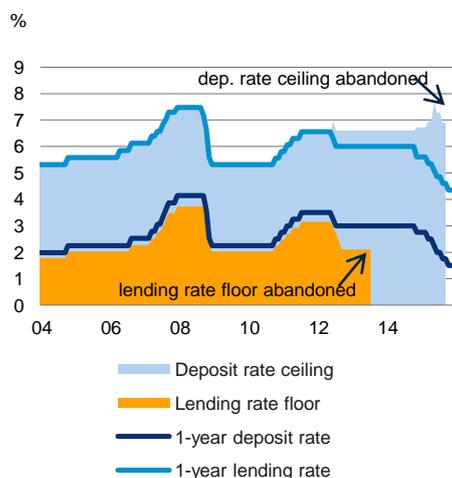
On corporate governance, China has made considerable strides by setting new benchmarks for improving governance in listed companies, as well as for advancing the use of accounting standards in line with international standards.²⁸ Notwithstanding the set of formal requirements in place, implementation on the operational level appears to still deviate substantially with respect to accounting and auditing practices.²⁹

The legal framework for safeguarding property rights and competition policies remains work in progress. Although the 2008 established Anti-Monopoly Law formally complies with international standards, prevailing exemptions as well as controversial enforcement practices continue to raise criticism. A prominent case in point was the 2014 crackdown on mostly foreign automobile and technology companies. The Bankruptcy Law of 2007 follows international standard, yet the tolerance for corporate defaults and bankruptcies has been limited to a few benchmark cases. State-owned enterprises (SOEs) continue to benefit from preferential access to finance and remain broadly shielded by implicit guarantees.³⁰ As a result, allocation of financing tends to remain skewed despite targeted initiatives to support small and medium enterprises, including facilitating their access to loans. On the whole, SOE reform has largely failed to deliver on equal market access, finance and investment for private enterprises.³¹

China's bid to open up the financial sector to allow more market forces has perhaps drawn most attention in recent years. Acceleration of financial sector reform after the Third Plenum brought about milestones such as introduction of deposit insurance and full interest rate liberalisation. By contrast, allocation of credit and many financial sector activities continue to be directly controlled by the government. What is more, progress of the past has to be measured against the growing challenges from China's economic slowdown as well as increased efforts to curb excess market volatility. The role of state intervention in the 2015 boom and bust in equity markets as well as recent action to tighten capital controls have clouded the outlook for a smooth and effective transition towards a more “market-based” structure. Persistent pressure on exchange rate and capital outflows could slow down the pace of further deregulation and capital account opening. At the same time, reversal of the achievements, notably on the legal framework, is not an option. Especially in a slowing growth environment, China may need to start tweaking remaining preferential policies so as to seize opportunities from more effective resource allocation.

Interest rates gradually liberalised

13



Sources: IMF IFS, People's Bank of China, Deutsche Bank Research, media reports

²⁶ According to the Catalogue for the Guidance of Foreign Investment Countries No. 22 (Amended in 2015): http://www.fdi.gov.cn/1800000121_39_4830_0_7.html

²⁷ US-China Economic and Security Review Commission (2015).

²⁸ See IFRS press release. IFRS <http://www.ifrs.org/Alerts/PressRelease/Pages/China-to-explore-further-use-of-IFRS.aspx>

²⁹ See for example Piotroski and Wong (2012).

³⁰ IMF Staff Report (2015).

³¹ OECD (2015).



Ending China's differential treatment

Decisions about China's future AD treatment are going to take place against this backdrop and might particularly come into play once a Commission proposal for future treatment is on the table to be debated in the Council and the European Parliament – with the latter already involved in controversial discussion at the beginning of the year.

Outlook

Given the importance of China-EU trade and the various (potential) ramifications of changing China's treatment in anti-dumping investigations, the provisions in the accession protocol were unlikely to expire quietly. However, the current timing poses some additional challenges as the decision how to treat China coincides with greater uncertainty with respect to the Chinese economy and policy direction, a slow recovery with persistent and high unemployment in a number of EU member states and sectoral concerns, particularly for steel. Several probes concerning steel imports from China are still ongoing and three new anti-dumping investigations concerning Chinese steel products were launched in February 2016. Moreover, provisional anti-dumping duties were imposed on cold-rolled flat steel from China.³² Similarly, there might be a tendency to bring cases forward now in other sectors, too to have them examined under current rules or re-examine duties about to expire. Nevertheless reconsidering AD arrangements with respect to China should also look beyond immediate concerns, ensure that rules are solidly grounded and reflect the needs of an increasingly globalised European economy.

Changing treatment of China in AD investigations and reconsidering its status as a non-market economy is not a negligible decision for the EU and warrants thorough investigation. To that extent, the Commission has announced a further in-depth assessment, and a public consultation has been launched in February to better involve stakeholders. Both should contribute to inform next steps, put a proposal for a solution on a sound basis and increase acceptance. While the political discussion and further Commission assessment is going to continue in spring, a formal decision would be expected rather later this year.

Rules for contingent protection in general are essentially about striking a balance – with respect to compliance with and acceptance of trade rules, relations with trading partners and domestic concerns. The current debate about rules to be applied with regards to China similarly reflects these considerations. The Commission has to walk a tightrope when proposing an approach, balancing concerns of the different market participants affected as well as member states, which have often held divergent positions on AD in the past.

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³² European Commission (2016b).



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