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CHINA'S MARKET ECONOMY STATUS AND EUROPEAN ANTI-DUMPING REGULATION

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Introduction

In international trade importing countries can be confronted with foreign firms that charge export prices which are below the exporters' production costs or prevailing market prices. This sort of price manipulation is referred to as price dumping and represents unfair competition behaviour by foreign firms. The reasons for 'price dumping' range from reducing excess capacity in the exporting country to the intended harming of competing firms in the importing country.

To prevent this sort of unfair competition, the European Commission can impose anti-dumping (AD) duties on foreign exporters. AD duties thus belong to the set of temporary trade protection instruments that can be used to restore fair competition between foreign and national firms by eliminating unfair price differences. Each country or association of states such as the European Union (EU) formulates its own AD regulation. However, the World Trade Organisation (WTO) defines general guidelines on the implementation of AD duties – including ways to calculate dumping margins and thus the level of punitive tariffs – which member states have to comply with.

Several factors play a role when it comes to determining the dumping margin. One decisive legal element is whether the dumping exporter's country is granted Market Economy Status (MES). All exporting countries that have received MES can be treated differently in the determination of dumping margins than countries with a so-called Non-Market Economy Status

(NMES). Interestingly, MES is legally relevant only in AD proceedings. The term is used to classify countries and hence allocates respective countries to different AD regulations. In this sense, MES represents more of a technical term with the real economic system of respective countries playing a minor role. It has to be emphasized that a country can be granted MES even when it does not operate a market-based economic system, as long as relevant economic conditions are satisfied.

The EU – together with several other WTO members including the United States – treats China as a Non-Market Economy (NME). This classification is essential in the EU's anti-dumping procedure as it determines the circumstances under which AD measures are allowed and how dumping margins are calculated. The legal foundation for this can be found in Article 15 of China's Accession Protocol to the WTO, which came into effect in 2001. It allows WTO members to determine by themselves whether they grant China MES; and subsequently which methodology to apply to calculate dumping margins. In December 2016, Paragraph (a) (ii) of Article 15 in China's Accession Protocol to the WTO is about to expire. As this paragraph is crucial to legitimize the implementation of specific AD proceedings against China, a controversial debate among different stakeholders has emerged.¹

This article provides an overview of possible courses of action for the EU and potential consequences for the European economy. Beyond first order effects on output and employment, these include wider implications both for the EU's relations with China, as well as with other countries, particularly the United States.

Market Economy Status and its significance in AD proceedings

The WTO defines dumping as selling a product at a price below its normal value. This means the price is either 'less than the comparable price in the ordinary



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¹ For a broader overview of this topic, readers are referred to a study conducted by the Ifo Institute on behalf of the European Parliament – *New Trade Rules for China? Opportunities and Threats for the EU*.

course of trade' or, in the absence of comparable domestic prices, 'less than the cost of production of the product in the country of origin plus a reasonable addition for selling cost and profit' (GATT 1947; WTO 1994).

In cases where dumping is detected, the importing country is allowed to set an AD duty, which may not exceed the difference between the normal price and the dumped price (dumping margin). This procedure is also followed by the EU. In addition to the fact that a foreign producer's export prices are too low, dumping also has to harm the EU firms in question either through their loss of market share in their domestic market, or by forcing them to make staff cutbacks. Moreover, AD measures should not be against the broader interests of the EU and the possible negative consequences of AD duties must be included in the decision-making process.

When imposing AD duties, the EU follows the WTO's recommendation and applies the 'lesser duty' rule, which means that the AD duty is equal to either the dumping margin (normal value less import price) or the injury margin (EU producer's price less import price), whichever is lower (European Union 2009). For firms located in countries classified as market economies, the producers' export prices in the importing country (e.g. the EU) are compared to their domestic costs or domestic market prices (e.g. China). In the case of imports from countries with a NMES, it is argued that the state influences price formation. Therefore, *normal value* is determined on the basis of prices and costs in a third – also referred to as '*analogue*' – country. This constructed value is then compared to the average export prices of the specific sector in the exporting country. The analogue country needs to have MES.

There are also AD regulations in the EU for intermediate cases that fall between the two procedures outlined above. Companies within a NME can qualify for so-called *Market Economy Treatment* (MET) if they can verify that they are acting in a market economy environment. In cases where this is not possible, respective companies can still apply for a so-called *Individual Treatment* (IT) if certain criteria are fulfilled. These include – among other things – the free, market based, determination of export prices. Should a company qualify for individual treatment, the normal value is still obtained by using prices and costs in an analogue country. However, the export price is computed with the exporting producer's own data, rather than with aggregate data from the exporting country.

Finally, EU legislation makes it possible to give special treatment to certain producers within market economy countries. For this purpose, adjustments to normal values in specific industries are made in the way that producers in this sector are still subject to Non-Market Economy Treatment – NMET (Detlof and Fridh 2006; Puccio 2015). This concept was introduced when the EU granted Russia the MES in 2002 to ensure that appropriate punitive tariffs could still be imposed on specific Russian industries that remained strongly dominated by state-owned enterprises. The various calculation methods of dumping margins described above are summarised in Table 1.

Article 15 of China's Accession Protocol to the WTO states that China can receive non-market economy status within the member countries' AD regulations. It is only possible to use domestic prices or costs to determine normal values if a Chinese producer proves that product prices are set by the market. If compa-

Table 1

Overview of EU dumping calculation methods

	Country category	Company treatment	Constructed normal value (reference price)	Export price (used to calculate dumping margin)
1	MES	MET	Domestic prices / costs	Exporter's own price
2	MES	Adjusted normal value	Costs of other domestic producers / information from representative markets	Exporter's own price
3	NMES	MET	Domestic prices / costs	Exporter's own price
4	NMES	IT	Analogue country prices	Exporter's own price
5	NMES	NMET	Analogue country prices	Average export prices of exporting
Note: The choice of a reference price ('normal value') used for determining the dumping margin of exporters critically depends on the market economy status of the exporter. For exporters in market economies, domestic prices and costs are used. For exporters in non-market economies, prices in a third (analogue) country are used.				

Source: Ifo Institute; European Union (2002 and 2009).

nies are not able to provide sufficient evidence, the importing WTO member does not have to use the exporter's domestic prices to calculate normal values. Instead, an '*alternative methodology*' may be used which, however, is not specified by the GATT or the Accession Protocol. As a result, the EU follows its own methodology that is consistent with WTO criteria as outlined above.

Anti-dumping legislation around the world

According to the definition by the UNCTAD (United Nations Conference on Trade and Development), a market economy relies heavily upon market forces to determine levels of production, consumption, investment and savings without government intervention. However, the decision over China's Market Economy Status and hence its treatment in AD cases depends mainly on national law.

A comparison of AD legislation between China's major trading partners (including the United States, Argentina, Australia and Brazil) conducted by the Ifo Institute illustrates a large overlap of defined criteria that need to be fulfilled by a country to receive MES. In their assessment all countries account for the price formation process, while non-market economy conditions are considered to be reflected in an unbalanced interaction between demand and supply. In addition, all considered countries account for the degree of state interference such as input choice, as well as the convertibility of the currency (except Malaysia and Australia). Malaysia, Brazil, Argentina and Australia have currently granted China market economy status. Overall, out of the 32 WTO members that have initiated AD proceedings against China, 14 have granted it market economy status. Nevertheless, granting MES to China does not necessarily change the AD treatment of a country (as can be seen in the case of Argentina or Brazil).

Anti-dumping in the EU and the United States – key differences

Comparing the EU and the United States MES criteria illustrates the implications of the respective rules for AD proceedings. For example, the EU may grant MET to individu-

al companies, whereas the United States may grant a form of individual treatment to producers or declare individual industries to be 'market-oriented' (United States Government Accountability Office 2006). As shown in the next section, average AD duties levied on firms with MET are lower than those on firms receiving the standard procedure for companies in countries with NMES (Figure 1). This pattern is most likely the reason why AD duties in the EU turn out to be lower on average than AD duties in the United States. The recognition of MES for individual companies therefore appears to be a more liberal approach than the imposition of AD duties on the industry level.

Moreover, the EU and the United States fundamentally differ in the way they choose an analogue country to determine normal values. The only requirement in the EU is to choose the analogue country 'in an appropriate and timely manner', whereas the United States applies stricter rules. For example, the analogue country should be a significant producer of the respective good, have a similar per capita income and should generally feature a similar economic development level to that of the exporting country under investigation. As a result, in the EU the United States is chosen most often as a third country, while the United States typically chooses India. Choosing India as the analogous third country should intuitively lead to lower AD duties compared to choosing the United States with its higher wages and price levels. The main differences between the EU and the United States are summarised in Table 2.

The effect of granting MES to China on AD duties

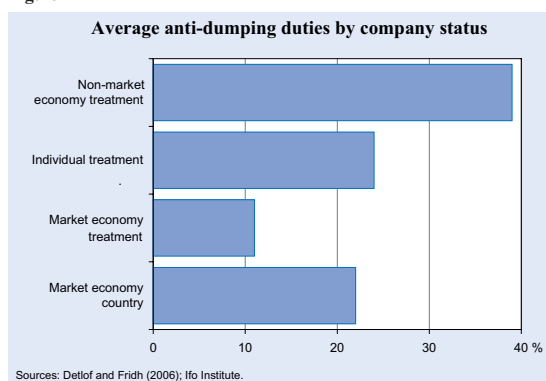
Comparing a country's export prices with those of a third country, instead of using domestic prices or

Table 2

Key differences between the EU and the US anti-dumping procedure against China	
EU	USA
MET possible for individual firms	IT possible for individual producers (conditions differ from MES criteria); MET treatment possible for individual industries
Analogue country to be 'selected in a not unreasonable manner' (main analogue country: US)	Analogue country to have similar level of development and wages (main analogue country: India)
No such provision	Condition of market economy includes such factors as the administering authority considers appropriate
Applies lesser duty rule (injury margin vs dumping margin)	No such provision

Source: Ifo Institute.

Figure 1

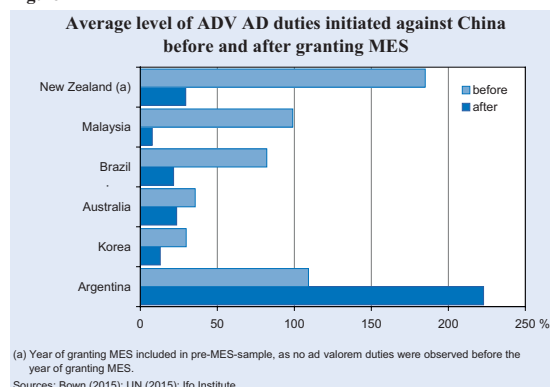


costs, tends to result in higher dumping margins. In fact, research by Detlof and Fridh (2006) reveals that the methodology used to calculate dumping margins has visible effects on the levels of AD duties imposed on a company. Figure 1 shows the average duty for NMET companies to be 39 percent, 24 percent for companies receiving individual treatment and 11 percent for companies receiving MET. These results are similar to the findings of a sample conducted by the Ifo Institute that comprises AD duties in force between 2005 and 2010 against 20 products produced by several Chinese companies.

An important question that arises at this point is whether this relation is causal. On the one hand, the methodology used to determine dumping margins could have a substantial influence on the level of AD duties. According to research by Roberts (2008), the analogue country system might lead to a price bias if important market characteristics such as the wage level differ between the third country and the addressed country. As a result, abolishing this principle could lead to a fall in constructed dumping margins (Roberts 2008), rather than actual dumping margins. Under these assumptions, granting MES to China would lead to considerably lower AD duties. On the other hand, big differences in dumping margins could stem from a systematic selection, as certain Chinese firms can apply for MET if they can prove that they are acting under market economy conditions. If this group of firms practices only little or no price dumping, the resulting average dumping margins, and AD duties as a result, would be considerably lower.

According to Scott & Jiang (2015), granting China market economy status would reduce the average duties imposed by the EU by 28 percentage points. This corresponds to the difference between average AD du-

Figure 2



ties against firms in countries with NMES (39 percent) and companies receiving MET (11 percent, see Figure 1). However, the drop in AD duties is not necessarily that high if the selection theory outlined in the paragraph above applies. In this case, the more competitive firms would already have self-selected into the MET group. Consequently, granting MES to China would reduce AD duties by less than predicted by Scott and Jiang. Instead, a drop to the value of about 22 percent for market economy countries reported in Figure 1 seems more likely.

A look at those countries that have granted China market economy status shows that average levels of AD duties fell after granting MES to China (with the exception of Argentina, Figure 2). This is in line with the observation of lower EU AD duties levied on MET firms.

A comparison of AD initiations across countries in Figure 3 and Table 3 reveals that countries that have granted market economy status to China on average initiated fewer AD cases against China – also relative to their overall initiations – (on average 22 percent) compared to countries that did not grant MES to China (on average 28 percent).

Figure 3

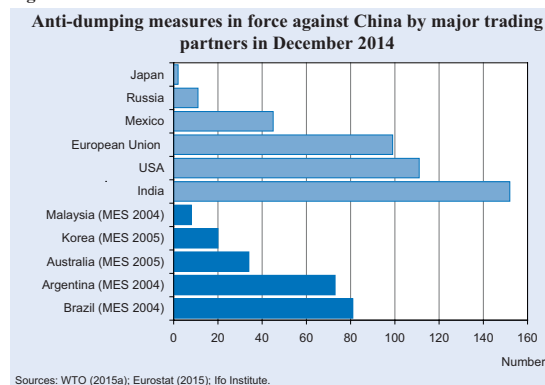


Table 3

**AD initiations against China
as % of total AD initiations**

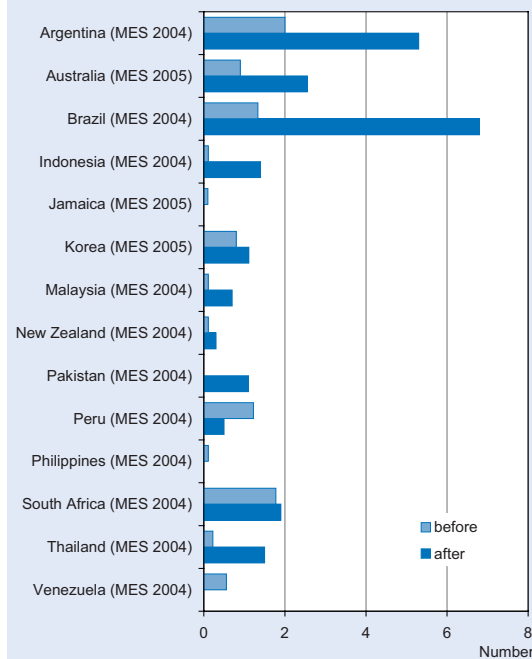
NMES	
Mexico	40
Russia	29
European Union	28
USA	26
Japan	25
India	23
MES	
Argentina (MES 2004)	32
Brazil (MES 2004)	25
Korea (MES 2005)	22
Australia (MES 2005)	18
Malaysia (MES 2004)	13

Source: Ifo Institute; WTO (2015a); Eurostat (2015); UN (2015).

Looking at individual countries over time, there is, however, no evidence of a fall in AD initiations after granting MES to China. Figure 4 illustrates the average number of initiations *per annum* for those countries having granted MES to China both before and after their doing so. The values for Argentina and Brazil are particularly remarkable because their AD initiations increased quite dramatically after granting MES to China. However, they only signed a memorandum of understanding, so they did not change their treatment of China in their AD procedures (Urdinez 2014; Puccio 2015).

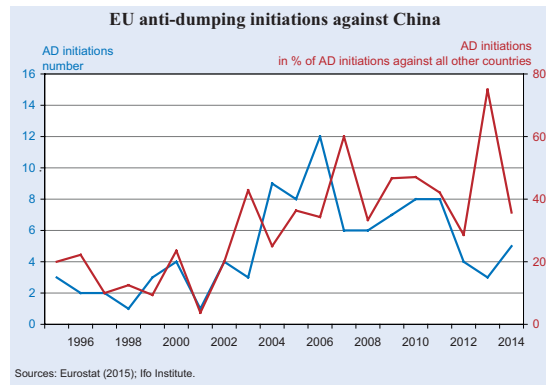
Figure 4

**Average number of AD initiations against China per year,
before and after granting MES**



Sources: Urdinez and Masiero (2015); WTO (2015a); Ifo Institute.

Figure 5



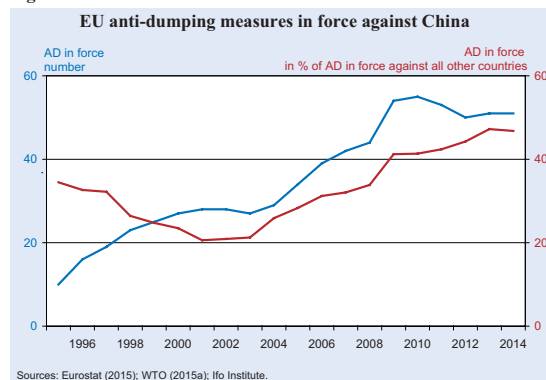
EU anti-dumping cases against China

Between 1995 and 2014 the EU initiated 99 AD cases against China. This constitutes 28 percent of overall European AD initiations in that period. Figure 5 clearly illustrates that AD initiations actually increased after China's accession to the WTO in 2001 – there were six initiations per year on average after the accession, versus only two annual initiations prior to it. Moreover, there is no clear relationship between the number of EU AD initiations against China and the relative importance of Chinese imports into the EU.

Figure 6 summarises the number of European AD measures in force against China at the end of each year, both in absolute terms and as a percentage of overall measures in force against all countries. Accordingly, there is a clear trend reversal, with an increase in AD measures in force against China to 51 (47 percent of total) in December 2014, up from only 28 (21 percent of total) at the end of 2001.

It is difficult to come up with an explanation for this increase in AD cases from 2002 onwards. On the one hand, WTO membership could have established a legal framework, facilitating AD investigations. On the

Figure 6



Sources: Eurostat (2015); WTO (2015a); Ifo Institute.

other hand, China's WTO entry was accompanied by an increase in trade volume, which simply offers more potential for trade conflicts.

Differences across countries

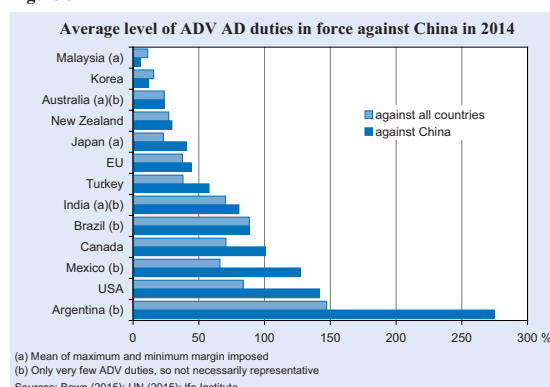
When it comes to imposing AD duties on China, the EU emerges in third place in the global ranking behind India and the United States (Figure 7). Overall, AD initiations against China have increased since the country's WTO accession, but started to fall back again as of 2009. This decline was mainly due to Argentina, India and the United States, which reduced their AD initiations from 2009 onwards. The number of initiations has started to climb again since 2009.

AD duties may be specified as *ad valorem* (ADV) or specific tariffs. Out of the 49 AD duties in force against China levied by the EU in 2014, 41 were ADV duties. This permits an easy comparison of duty levels across countries (Bown 2015). As Figure 8 illustrates, the average AD duty set by the EU was much lower than the average duty imposed by the United States (44 percent vs. 142 percent). The average AD duty levels in Argentina and Mexico were also extremely high. However, they are not directly comparable as only a small fraction of AD duties were ADV.

Sectoral and regional heterogeneity influences anti-dumping investigations in EU countries

Within the EU both the number of AD initiations, as well as the level of resulting duties, varies strongly across different sectors. Once imposed, AD duties affect imports into all EU countries. However, looking at the firms that have initiated the investigation may help to identify those most heavily affected by Chinese

Figure 8



dumping behaviour. Italian, German, French and Spanish companies are most often involved in AD cases. This is not particularly surprising considering that these countries are also Europe's largest economies (Figure 9). A comparison of the number of AD measures against China relative to all other countries, however, reveals that companies in Portugal, Belgium and Poland² target Chinese companies more often than those in other countries.

Looking at the level of AD measures draws a different picture. Firms in Sweden, Romania, Latvia, Hungary and Denmark have initiated cases that led to the highest levels of AD duties. Moreover, Sweden, Slovenia, Romania and Hungary are the countries with the largest difference between duty levels imposed on China and those imposed on other countries. This heterogeneity across countries could be a result of differences in the economic structures of European states. If a country's economy relies heavily on a specific sector that suffers in particular from dumping by Chinese firms, a higher average level of AD duties is likely. This line of reasoning is supported by Figures 9 and 10, which show that large countries like Germany and

² Firms from Latvia are overall responsible for only one AD initiation against China.

Figure 7

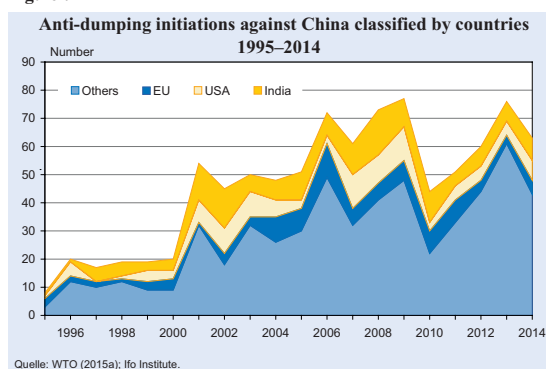


Figure 9

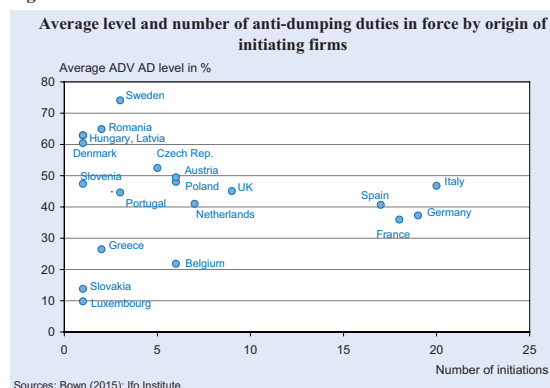
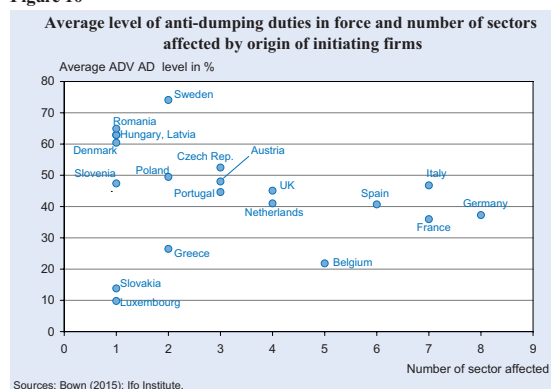


Figure 10

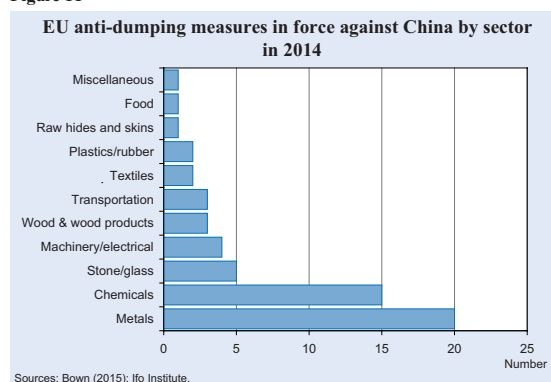


France have many AD cases in different sectors, whereas in smaller countries like Sweden or Denmark, AD cases are concentrated in fewer sectors. Consequently, in these countries individual AD cases have a strong impact on the average level of AD duties.

Sectoral differences and comparative advantage

Looking at specific sectors, most AD cases in force against China are concentrated in the metals and chemical industry (Figure 11). This observation is interesting because China appears to have a comparative advantage in the metals sector compared to the large European countries, meaning that China's metal industry is on average more productive than that of its European competitors (Leromain and Orefice 2013). However, the data does not provide a clear interpretation of the causal relationship between comparative advantage and AD duties. On the one hand, Chinese producers could indeed possess a real cost advantage (due to lower resource and labour costs, for example). On the other hand, the observed advantage could stem from dumping activity. In that case the price of steel in China would not reflect the 'true resource cost' (Ruiz, Somerville and Szamosszegi 2015).

Figure 11



A concentration of AD cases in a few sectors is also observable in several non-European countries. In sectors in which countries have a comparative disadvantage, AD cases are more frequent. Statistically, a weak negative within-country correlation exists between comparative advantage towards China and the number of AD measures. Nevertheless, the chemical sector – in which China appears to exhibit a comparative disadvantage – is also frequently targeted. Finally, there is no characteristic relationship between the structure of comparative advantage and the decision to grant MES to China.

To summarise, the descriptive statistics indicate that AD measures in the EU are concentrated in specific sectors, implying a particular vulnerability towards dumping by Chinese firms. As a result, even if the EU grants market economy status to China, individual sectors might demand continued special protection.

Implications for future negotiations and trade agreements

Beyond direct output and employment effects, the EU's decision to grant MES to China will certainly affect the general atmosphere of commercial relations between the two entities. First of all, the decision could influence China's behaviour in WTO negotiations and result in the prolongation of cases and increasing dispute complexity. Moreover, not granting MES to China could threaten the Sino-European bilateral investment treaty (BIT). This treaty aims to reduce the investment barriers faced by European companies in China. In this context the Chinese government may certainly question why it should promote foreign investment while the EU continues to apply strict AD regulation based on the assumption that Chinese companies do not act under market economy conditions. Similarly, the price bias resulting from constructed dumping margins using analogue country costs and prices could put pressure on EU regulation as discrimination against Chinese imports cannot be sustainable within WTO rules.

Unilaterally changing China's market economy status may also affect the EU's relations with third countries, particularly the United States. This is because increased imports from China may cause trade diversion, as cheaper Chinese imports constitute a substitute for imports from other countries. At the same time, European producers might benefit from cheap

Chinese intermediate products, providing them with a cost advantage *vis-à-vis* US producers and thus putting the latter under pressure in the European as well as in the US market. This is a particular concern for US steel producers, who are demanding that the issue be included in the ongoing TTIP negotiations.

The effect on EU employment

As for the expected employment effects of granting MES to China, European institutions frequently refer to research by Scott and Jiang (2015). In their research, the authors come to the conclusion that unilaterally granting MES to China would endanger up to 3.5 million jobs and reduce EU output by up to 228 billion euros per year. However, Scott and Jiang (2015) make strong assumptions that might not yield realistic estimates. For example, one assumption is that all Chinese companies will receive MET in the future, which would lead to a drop in average AD duties of 28 percentage points. It might be more realistic to use the market economy average, which would only result in a 17 percent drop in average duties.

Moreover, only a small share of imports is affected by AD duties (2 percent in 2014, see European Commission 2014). With imports of goods and services of 325 billion euros in 2014, this only amounts to 6.5 billion euros. Even if the deterring effect of AD duties is taken into consideration, the estimated drop in production of 228 billion euros does not appear realistic.

Long-run impacts

The current political debate on AD duties overlooks the dynamic aspects of trade policy. In general, using AD duties to address unfairly traded goods is an option that the EU can consider. However recent research suggests that duties may not be an appropriate instrument for eliminating price distortions in the long run.

AD duties tend to reduce imports from the target country in the short run. However Lu, Tao and Zang (2013) find that an undiversified AD regulation against China leads to fiercer competition in the long run. They argue that AD duties force the least productive firms out of the market. The remaining productive firms may become even more competitive by fur-

ther reducing their production costs, and may increase their exports in the long run as a result. AD duties could thus lead to unintended adjustments in the exporting country. They should therefore be viewed in a broader context when discussing a reform of trade protection regulation.

Finally, price dumping is an economic phenomenon that should be mainly regulated by competition law. After all, imposing AD duties is a so-called ‘second best’ solution. Since the EU does not have a say on Chinese competition law, the EU uses trade regulation instruments to compensate for its lack of influence. However, the bilateral investment negotiations may offer a great opportunity to define transparent competition regulations, including the problem of price dumping. Such a procedure would result in a considerably weaker goods trade distortion with China, and would thus constitute a potential political ‘first best’ solution.

Conclusion

Paragraph (a) (ii) of Article 15 in China’s Accession Protocol to the WTO is due to expire in December 2016. There are controversial discussions among members of the WTO, including the EU, over the degree to which trade protection duty regulations against China have to be adjusted. The discussion is dominated by political arguments, while important economic aspects are left aside. Today there are many different regulations in the EU, as well as in other countries, on how to deal with unfairly traded exports – from China for example – by imposing anti-dumping duties (punitive tariffs) to ensure a fair price level. As a result of the different procedures, AD duties against China differ considerably between the individual member states of the WTO.

If the EU grants China MES, the respective average of AD duties is mostly likely to drop. Yet given existing research, it is still difficult to estimate the extent of this drop. An average decline of between 17 and 28 percentage points is suggested in several studies. As a result of this reduction in AD duties, an increase in Chinese imports to the EU together with a decline in employment in the affected sectors is expected. However, the extent of this effect on employment varies greatly between the different studies and is partly based on very extreme assumptions.

Both the European Commission and the European Parliament have to decide on a law that has a long run impact on both bilateral trade relations with China and their economic relationship with important third countries such as the United States. Individual sectors such as the European metal and chemical industry have justified reasons for demanding legislation on China, which still makes it possible to deal with unfair competition through the use of trade defense instruments.

At the same time, discussions of the pending law change in AD regulations have to be viewed in a broader context. China is an important economic partner for the European Union. A substantial share of EU exports is based on cheap intermediate goods imported from China, which help European producers to remain competitive in world markets. Moreover, the EU currently intends to improve the bilateral economic relationship with China by means of a new investment agreement. In this broader context, a confrontation with China by maintaining a rigid AD regulation does not appear particularly far-sighted. Nevertheless, the EU should take into account the justified concerns of individual sectors – such as the metals and chemicals industry – as well as the reasonable Chinese expectations by means of a cooperative adjustment in AD regulation.

Therefore, instead of granting or refusing China market economy status, there is a possible cooperative third option, which would provide the EU with a certain margin for discretion in certain cases. This option could involve China receiving MES after the expiration of paragraph (a) (ii) in Article 15. Nevertheless, firms in individual sectors could still be treated as firms in a NME. Such a procedure was used for the first time after MES was granted to Russia in 2002. Further investigation will be necessary to verify the legal and practical feasibility of this third option in the case of China.

Overall, this short analysis demonstrates the urgent need for detailed empirical research in order to obtain reliable estimates of the effects of the discussed economic adjustments. European decision-makers should not let themselves be influenced by individual interest groups, but should follow a broader approach instead that takes into account the relevant empirical studies on the matter.

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