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How to Unlock the WTO Blockage and Why China Holds the Key

The WTO has been getting into an ever-deeper crisis in recent years, even though it had been a success story at its outset in 1995 and for several years afterward (Kolev and Matthes 2020). And still in 2001, despite the upcoming anti-globalization criticism, the start of the Doha Round in 2001—shortly after the 9/11 terror attacks—it was understood as a strong signal for multilateral cooperation toward further trade liberalization. At the end of 2001, admitting China to the WTO was considered an important milestone as well.

However, for several reasons, the Doha Round got stuck (Matthes 2006)—among them many countries' fear of rising competition from fast-growing China. In consequence, the trade liberalization function of the WTO proved to have lost its power. In broad terms, the WTO's function of monitoring new trade barriers functions well despite some room for improvement, as was the case in and after the global financial crisis in 2008/9 and during the coronavirus crisis. However, the WTO's liberalization function, probably its most important objective, has also been dealt a serious blow. The Appellate Body (AB), the second stage of its dispute settlement system, has been out of order since December 2019 because the US has continually blocked the nomination of new trade experts as members of the AB.

There are very fundamental disagreements behind the WTO crisis, including globalization skepticism, rising state influence and protectionist industrial policies. Moreover, there is a deep divide and distrust between emerging and developing countries on the one hand and industrialized countries on the other about opening up markets for agricultural goods (desired by the first group and resented by the second) and opening up markets for industrial goods and services (desired by the second group and resented by the first). However, the elephant in the room is China with its state capitalism. The Chinese economic model is based on a domestically relatively successful industrial policy that, however, increasingly leads to competitive distortions in world markets to the benefit of Chinese firms and to the detriment of others (Matthes 2020a). These spillovers of China's state capitalism could eventually put the WTO in jeopardy. Therefore, China is a key player in saving the WTO and in ending its crisis. This claim will be elaborated on and discussed in this article with a focus on a possible solution to the AB crisis.

WHY TRUMP'S WTO BLOCKAGE DID NOT COME OUT OF THE BLUE

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Seeing China (also and mainly) in charge of saving the WTO stands in stark contrast to the commonly held view that only the Trump administration can end the WTO crisis because it is commonly regarded as the main culprit for causing the blockage. At first glance, the evidence seems to support the latter standpoint: indeed, it was Donald Trump who blocked the nominations of new AB members until the WTO's demise, and he is also the one who recently vetoed the nomination of a new Director General (DG) to head the WTO, although a majority of WTO members supported Ngozi Okonjo-Iweala, the candidate from Nigeria. Moreover, blocking the AB was likely also motivated by the intention of the Trump administration to avoid a final and binding AB verdict regarding the tariff measures of the US on China and on steel/aluminum that are based on alleged national security reasons. Moreover, there was a deep resentment of multilateralism throughout Trump's trade team and the WTO for interfering in domestic affairs.

However, there are also deeper reasons behind the US actions, many of which have to do with China and its state capitalism. In fact, blocking the AB nominations had already begun under the Obama administration, and US discontent regarding the AB goes back much further than that (EP 2019). The longstanding concerns include various issues that were summarized, for example, in a Report by the United States Trade Representative (USTR 2020; Willems 2020; Fukunaga 2020). The US' main criticism is that the AB overstepped its mandate and indirectly created de facto new trade rules that diminished various US rights and created new obligations. In general, the USTR (2020, 2) criticizes that the AB's "errors have favored non-market economies at the expense of market economies." This relates especially to the use of trade defense instruments (TDIs) also and particularly against competitive distortions originating in China. TDI use was restricted in several respects according to USTR (2020). An important example is the AB's narrow interpretation of WTO law relating to the term "public body," which severely limits the scope for using WTO rules

to tackle the pervasive competitive distortions by China's SOEs.

From this viewpoint, the AB acted as a normal court in interpreting rules and established a new meaning pertaining to WTO law. However, the US holds the opinion that the AB is not a usual court but should stick very closely to WTO law. The US also criticizes other issues: it holds the opinion that the AB overstepped its mandate by creating binding precedent, interpreting domestic law, reviewing the panel's fact finding, and by issuing advisory opinions on issues not raised by WTO members in the relevant case. On top of this, there are several more technical issues the US had continuously criticized: appeal proceedings often took much longer than the foreseen 90 days provided for in WTO rules, and the terms of outgoing AB members working on ongoing appeals were sometimes extended for longer periods without clear consent of WTO member states. Many of the aspects criticized by the US are reasonable and are thus shared by the EU and other WTO members (European Commission 2018; Stewart 2019).

Put in a broader and more general context, after the foundation of the WTO the AB acted in the liberal sense of the time when trade openness was still the prevalent mantra. However, China challenges this view with its state capitalism and its immense export market gains that operate partly at the expense of others. In fact, the combination of China's technological catch-up (fostered by unlawful forced technology transfer), the competitive distortions of its industrial policies, and China's enormous and growing size pose the danger of welfare losses for industrialized countries (Matthes 2020b).

TDIs are limited tools for countering this trend. However, the AB restricted their use, even though the US has always seen TDIs as tools that are mainly within the national realm of WTO members. Therefore, there is some reason for the US believing its faith was betrayed when it agreed at the time the WTO was founded to TDI rules that still allowed for a wide scope for national determination and at the same time to a binding dispute settlement system. The same is true in relation to the agreement of the US to China's accession to the WTO, which was related to the expectation that over time, China would gradually become a market-based economy with a democratic system like Japan's and South Korea's. Viewed from this perspective, the AB has changed the rules of the game and this has become ever more relevant due to the increasing spillovers of China's state capitalism.

HOW TO SOLVE THE APPELLATE BODY CRISIS WITH THE BIDEN ADMINISTRATION

The Trump administration blocked reform efforts in the WTO to resolve the AB crisis (Stewart 2019). Now, there is nascent hope of moving forward with the Biden administration. But this will be no panacea, because the Democratic Party is no staunch supporter of the WTO and also criticizes many of the above-mentioned shortcomings of the AB. Moreover, existing US tariffs on steel and on China could still be a hindrance. However, President Biden's generally positive attitude toward multilateralism could open the door toward a more constructive cooperation with the US on AB reform.

An additional incentive for the US to engage in this respect lies in the temporary dispute settlement solution that some countries have set up as an interim alternative to the AB—the MPIA (Multiparty Interim Appeal Arbitration Arrangement). The MPIA was initiated by the EU and Canada and went into force at the end of April 2020 (WTO 2020). It is an open agreement among all WTO members. In the meantime, around 20 countries have joined, among them China, Brazil, Mexico, Australia, and Switzerland—but not the US. However, the EU and other countries have "catered for the event" that in a bilateral trade dispute the US could appeal into the legal void after a panel finding against its interests. In such a case, the EU will now be able to apply counteractions on US exports based on the panel finding, i.e., the first stage of the dispute settlement mechanism. This had not been possible before. Thus, the EU had to reintroduce this enforcement mechanism, which it did only recently. It allows for counteractions in the form of higher goods tariffs, limited access to European public procurement as well as the withdrawal of service liberalizations or of intellectual property rights. This step allows the EU greater discretion compared to the WTO rules based on an AB finding so that potential countermeasures against the US could be more severe. The Biden administration might use this argument in the domestic public debate to justify an engagement on AB reform. This would also be in the interest of the EU, as the MPIA is very clearly intended to be merely an interim solution until a reformed AB is installed.

There are good starting points for a new cooperation with the Biden administration on reforming the AB: as early as 2018, the EU presented a concept paper on WTO reform which, among other issues, also deals with the US' concerns with the AB (European Commission 2018). Also on this basis, there were broad discussions within the WTO and a serious attempt to resolve the critical issues (the "Walker Process"). David Walker, New Zealand's ambassador to the WTO, informally consulted members in search of issues of convergence and eventually produced a draft General Council decision on the functioning of the AB (WTO 2019). The draft decision tackles many of the issues raised by the US. It stipulates that the Appellate body "cannot add to or diminish the rights and obligations provided in the covered agreements," and that "precedent is not created through WTO dispute settlement proceedings" (WTO 2019, 6). Moreover, domestic law (in the sense of municipal law) is to be "treated as a

matter of fact" and the AB must not engage in new fact finding. Related to the more technical issues, it is reiterated that the AB is to issue its report within 90 days except for special circumstances. Concerning outgoing members, it is stated that only WTO members can decide upon AB members and that outgoing members would only be allowed to continue an appeal process with this clear consent, which would be given more than 60 days before a term ends.

However, the Trump administration criticized that the reformed wording did not go far enough to ensure a sufficient change in the AB's behavior by stating their distrust toward other WTO members who did not share the view of the AB's shortcomings (Stewart 2019). While the Biden administration might be more constructive and build upon the "Walker process," some further work on the draft General Council decision might be needed. Many experts have made suggestions to this aim (Willems 2020; Stewart 2020). One important problem that may also have to be dealt with is correcting past AB findings that restricted the use of TDIs.

In addition to the above-mentioned efforts to "ensure the use of existing TDIs" as foreseen in WTO law, it is indispensable to "expand the remit of TDIs." Particularly regarding the WTO's Agreement on Subsidies and Countervailing Measures (ASCM), there are large regulatory gaps that prevent leveling the playing field with regard to various forms of trade-distorting subsidies (Matthes 2020a). Also in this respect, there is a foundation to build upon. In fact, a Trilateral Meeting of the EU, the US and Japan has proposed reforms to broaden the definition of prohibited and actionable industrial subsidies, including stricter disciplines on SOEs (Joint Statement 2020). For example, the following subsidies should be unconditionally prohibited in the future: unlimited guarantees, certain direct forgiveness of debt and subsidies to an insolvent or ailing enterprise in the absence of a credible restructuring plan. These proposals should be officially tabled in the WTO and the three countries should seek broad support for their initiative among like-minded WTO members.

Moreover, apart from the AB, there is also room for fruitful cooperation between WTO members with the US on other important issues regarding the WTO (Matthes 2020c). Some of these issues shall be briefly mentioned:

- There is hope that the Biden administration will consent to Mrs. Okonjo-Iweala and enable the WTO to get a new Director General.
- Constructive cooperation on smaller liberalization initiatives could help rebuild trust among the US the other WTO members (Evenett and Baldwin 2020). In fact, the lack of trust is a fundamental problem at the root of the WTO crisis. Issues that lend themselves for smaller, but still highly relevant initiatives include facilitating trade in medical goods in view of the Covid-19 crisis, concluding far-advanced negotiations on fisheries and concrete attempts to find common rules for open markets in digital trade.
- The burning issue of the relation between trade and climate protection needs to be discussed more intensively in the WTO in order to avoid future disputes. Such conflicts could easily arise, for example, if the EU introduced a carbon border adjustment mechanism to avoid carbon leakage due to its ambitious Green Deal, without first intensively consulting with its trading partners.

WHY CHINA HOLDS THE KEY TO SAVING THE WTO AND HOW BEIJING CAN BE INDUCED TO USE IT

Returning to WTO reforms of the AB and of the ASCM, both the US and China play an important role in saving the WTO from its crisis. In fact, many of the problems that make these reforms necessary boil down to China's state capitalism and the increasing spillovers from its subsidy system. It has been pointed out that a key reason for the US blocking the AB is due to the restrictions that the AB imposed on using TDIs to better level the playing field in view of dumped or subsidized Chinese products.

In this respect, the best solution for global trade would be for China to change its domestic policies and to limit competitive distortions at the root. However, as state capitalism has proved rather successful for China, this appears highly unlikely. A second option would entail Beijing acknowledging that the spillovers of its economic system undermine competitive conditions in the world market, and that its trading partners need to have instruments to neutralize these distortions in order to ensure a level playing field. The above-mentioned ASCM reform would be a key part of such a move.

However, despite numerous attempts to strengthen the disciplines on subsidies in the WTO and despite increasing pressure from the Trilateral Meeting, China continues to refuse to negotiate about an ASCM reform. Due to the WTO's consensus principle, the China's resistance (as well as that of some other nations) renders a meaningful reform elusive. A plurilateral subsidies agreement in the WTO framework might be seen as an alternative, but without China it would not be worthwhile. Bilateral approaches could be an additional alternative approach. However, the US, in its phase 1 agreement with China, and the EU with its investment agreement, succeeded only to a limited extent in increasing the disciplines on China's subsidy strategies. Moreover, it is clearly preferable to create better multilateral rules for anti-subsidy measures.

If China's state capitalism spillovers increase further, as might be expected, the danger arises that more countries follow the US approach and use TDIs and other tariffs against Chinese imports in a fashion that goes beyond WTO limits. In this case, it is

foreseeable that WTO disputes would increase significantly and that such defensive trade measures would be viewed as breaking WTO rules. However, it might get to the point that the countries using these measures will not comply with WTO dispute settlement findings, because this would lead to considerable domestic job loss. Such a constellation would lead to trade wars and further serious erosion of the WTO. This is why China's state capitalism might eventually put the WTO at stake. In other words, the following danger appears imminent in the near future: since an unchanged state capitalism system in a country as large as China does not fit into a largely market-based multilateral trading system, either China changes, the system changes, or the whole system could break down. Thus, more pressure on China to agree to WTO reforms is required.

Based on these considerations, Kolev and Matthes (2021) have put forward an ultima-ratio-proposal for cooperation between the EU and the US to increase the pressure on China. It boils down to opening the option to put the WTO at stake in order to save it—and with it the multilateral trading system as we know it. This strategy assumes—not implausibly—that only when the WTO benefits can no longer be taken for granted might Beijing move sufficiently on WTO reform.

The Kolev and Matthes proposal (2021) suggests a multi-regional plurilateral trade agreement of market-based economies spearheaded by the EU and the US that would also comprise Japan, the UK, Canada, Australia, Chile, Mexico and many other industrialized and emerging economies. The enormous size of the agreement would act as a gravitational force that would encourage further accessions. The agreement would build on and extend WTO rules so that new trade liberalization among like-minded countries becomes feasible. In particular, strong level-playing-field rules for SOEs and industrial subsidies would have to be defined and established. These rules would have to allow for a certain level of government financial support as is common in most countries. However, they would forbid excessive subsidization as is common in China (Think!Desk 2015 and 2019) and as the OECD has found in China in case studies on such differing sectors such as aluminum and semiconductors (OECD 2019a and 2019b).

Depending on China's preparedness to comply with subsidy-related reforms, the plurilateral agreement could be developed in different directions. First, China could be offered the option of acceding to the agreement, if it complies with its rules. Second, the rules of the agreement could be used as a blueprint for WTO reform to which China agrees. Third, if China were not prepared for one or both of these steps, however, the agreement could be developed into an alternative plurilateral arrangement with the WTO that could eventually substitute for the existing multilateral trading system. If concrete steps in this direction were effected, China should be given further chances to move on the required reforms.

Kolev and Matthes (2021) are aware of the grave implications of such a step, particularly for the EU as a staunch supporter of multilateralism and rules-based trade. However, they see the danger that the WTO could break down anyway, if China does not agree to WTO reform. Even if this outcome does not appear highly probable, preparing for such a scenario is essential. Since spillovers from China's state capitalism are increasing and since setting up such a plurilateral agreement would take time, it should be agreed upon sooner rather than later. One option could be to enlarge and adapt the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), the pros and cons of which are discussed by Matthes and Kolev (2020).

Such a plurilateral agreement is no panacea. For example, the US and the EU follow different approaches on many kinds of rules and standards in their bilateral free trade agreements, so that potentially difficult compromises would have to be found. However, the geostrategic value of increasing the pressure on China and of having an alternative ready if the WTO broke down should be a more important consideration. In addition, a plurilateral agreement would reduce the transactions costs of the multitude of intersecting bilateral trade agreements globally and clean up the so-called "spaghetti bowl."

It is to be hoped that the last-resort strategy of putting the WTO at risk is not needed because either the spillovers of China's state capitalism remain sufficiently limited or because China soon recognizes the necessity of a WTO reform along the lines laid out here.

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