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**The US and EU increasingly look to the WTO to help open China's markets**

**But the WTO is ill-suited to the task of forcing major domestic liberalization**

**Global trade rules do help contain the most egregious cases of protectionism**

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## China Policy Watch: World Trade Rules Playing To The Whistle

Does China play by the rules? This question has hovered over the country ever since it joined the World Trade Organization in late 2001, a move that symbolized its commitment to following shared rules of the game for the world economy. And in the first few years after its WTO entry, China enjoyed a honeymoon. Only one case was filed at the WTO challenging a Chinese regulation, and it was resolved quickly. But as China's role in the world economy has grown larger, and its huge market has become a focus for most of the world's multinational companies, its rules and regulations have come under increasing scrutiny. Since 2006 a growing stream of WTO cases has challenged China's laws for running afoul of free trade norms. Six new disputes were filed in Geneva by the end of 2008, and another ten have been launched since 2010, including one last week by the US against alleged export subsidies for automakers.

At first narrow and technical, the WTO cases pursued by China's trading partners have now become broad and complex, addressing a wide range of regulatory disputes. This increased use of the WTO's dispute resolution process is certainly understandable: China's trading partners have few other points of leverage against a large and financially self-sufficient sovereign nation. The WTO is the world's first and only binding system for resolving trade disputes, and China has so far yielded to its rulings. But while the WTO's rules do have teeth, it is not at all clear that they have enough bite to drive the economic liberalization in China that its trading partners so desire. And China may be less willing to comply if future WTO rulings start to challenge its core domestic priorities.

### Traffic cop on the trade beat

It's important to realize that the WTO was never intended to be a way to force broad changes in domestic regulation and economic practice—the US and EU have themselves strongly resisted attempts to use the WTO in this way. The WTO explicitly permits plenty of protectionism for reasons of health, safety, the environment and national security, and members regularly hide behind these rules to shield domestic industry. It is best to think of WTO rules as akin to traffic laws. Even the police don't expect everyone to stay under the speed limit all the time. The laws' purpose is to reduce the extent of speeding and reckless driving.

Seen in this light, we think WTO entry has been a positive discipline for China. The government takes some account of global trade rules when drafting its regulations, and China's discriminatory behavior has been less brazen since it joined the WTO. Most of its trading partners can also be reasonably confident they will get a result if they file a WTO case against China. China has lost most of the WTO cases brought against it, and has complied with WTO rulings by changing its offending regulations. In short, China has so far played by the WTO's rules. But the WTO is not a quick fix: it has taken anywhere from two to five years for a complaint to

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**China reviews its own rules for WTO compliance, but the process has many weaknesses**

**Only the WTO can judge whether its rules have been broken, a question China has faced 17 times already**

result in a change in China's regulations. And it is also true that a string of lost WTO cases has not fundamentally changed the heavily interventionist character of China's government policy. This continues to frustrate foreign companies, and could lead to more troublesome disputes down the road.

### **Righting regulations**

China's compliance with WTO rules started even before it joined, with a broad review of domestic regulation. From 1999 to 2002, the State Council and the predecessor to the current Ministry of Commerce (Mofcom) oversaw the revision of tens of thousands of national and local laws and regulations, as well as internal Communist Party orders. Mofcom now reviews all new national trade-related laws and rules for WTO consistency.

However, this review process is not binding or comprehensive. Individual ministries and commissions can decide themselves whether the measures they draft are "trade-related" or not. And Mofcom's opinions are not binding and can be ignored with impunity. For example, China's 2001 Copyright Law said that artistic works published abroad that were banned in China did not enjoy copyright protection in the country. This opened a huge loophole for piracy. Local experts at the time noted the inconsistency with WTO rules, but they were overruled. The US ended up successfully challenging China at the WTO over this language in 2007.

Such problematic cases continue to emerge. Earlier this year, the Ministry of Industry and Information Technology (MIIT) drafted a catalogue of cars it would approve government agencies to buy. MIIT did not ask for a Mofcom review, and faced a storm of complaints once foreign companies found out the list only included domestic models (the list did not apply to car purchases by senior officials). Local governments are also supposed to check their regulations for WTO compliance, but outside of Beijing, Shanghai, and Shenzhen, this review process is spotty at best.

The WTO's own processes are the only way to ultimately determine whether a Chinese regulation is in conflict with global trade rules. Any WTO member country can request consultations with another in Geneva about a regulation it believes is problematic. If no agreement is reached, the WTO forms a three-member dispute settlement panel, which reviews the evidence and rules on the case. The losing party can either accept the panel's verdict or go to the seven-member Appellate Body for a review. The body's decision is final, and the loser typically has one year from the date the verdict is issued to comply. If it does not, the winning side can institute sanctions as compensation.

To date China has been brought before these WTO bodies on 17 occasions, in most instances by the US. And like most respondents in most WTO cases, China has consistently lost (see table, overleaf). Out of the eight cases that have been fully resolved, in half of them China essentially conceded by withdrawing the measures at issue during consultations. In one case—the 2007 dispute over intellectual property rights—the verdict was mixed, with the WTO finding some violations but agreeing with China that its criminal penalties were not so low as to effectively encourage piracy. In the other three cases, the WTO ruled against China.

The real measure of whether China is playing by the rules is not whether it loses a case, but whether it actually changes its rules following a WTO

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**China has lost most of the WTO cases brought against it, and has eventually complied with those rulings**

**China's compliance with WTO rulings is so far better than the US or EU**

## Who will be the biggest loser?

WTO cases with China as a respondent

### Concluded cases

Filed	Issue	Resolution	Complied
Mar 2004	VAT rebates on semiconductors	Withdrew rebates	Oct 2005
Mar 2006	Tariffs on auto parts	Changed tariff rates	Aug 2009
Feb 2007	Unfair tax breaks, subsidies	Eliminated the rules	Dec 2007
Apr 2007	Inadequate protection of IPR	Revised regulations	Mar 2010
Apr 2007	Limits on media imports	Amended rules	Feb 2012
Mar 2008	Financial information services	Withdrew regulations	Nov 2008
Dec 2008	Subsidies for famous brands	Ended all programs	Dec 2009
Dec 2010	Subsidies for wind power	Ended subsidies	Feb 2011

### Ongoing cases

Filed	Issue	Current status
Jun 2009	Raw material export limits	Ruling against China in Jan 2012
May 2010	AD duties on fasteners	In consultations
Sep 2010	AD duties on electrical steel	China appealing Jun 2012 ruling
Sep 2010	Electronic payment services	Ruling against China in Jul 2012
July 2011	AD duties on x-ray equipment	Panel will rule by Dec 2012
Sep 2011	AD duties on chicken broilers	Panel formed May 2012
Mar 2012	Rare earth export limits	Panel formed Jul 2012
Jul 2012	AD duties on automobiles	In consultations
Sep 2012	Subsidies on autos, parts	In consultations

\*AD = antidumping

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defeat. So far China has generally abided by WTO rulings and made the necessary changes to its domestic regulations within the required time, typically one year from the date of a final decision. This is actually a better record than many other WTO members. The US has lost almost 40 times at the WTO, and in seven instances it has not complied with the WTO's ruling within the allotted time. The EU has not complied on time in three of the 21 cases it has lost.

The only time China did not comply on time was in the case involving distribution of foreign movies in China. This case was politically fraught: not only did it threaten the monopoly of the China Film Import-Export Corp., it also challenged the authority of Communist Party's propaganda bureaucracy. Eventually, China did reach a settlement with the movie industry, but the Party's authority to censor was left intact.

On balance, China's authoritarian system deserves some credit for its relative responsiveness. But why does it bother complying, if other WTO members can get away with not complying? There are several factors that have driven China's compliance so far. First, it is happy to discard some disputed measures because they have already achieved their desired effect by the time the WTO case is completed. For example, the tariff scheme for cars and car parts that was challenged in 2006 helped boost domestic

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**There are many reasons why China has so far opted to comply with WTO rulings**

**Its track record suggests China will also fall in line on the latest rulings against it**

**But as trade disputes escalate, this pattern of compliance may not hold forever**

manufacturers, but by the time China was required to comply three and a half years later this support was no longer necessary. Though it was clear China would lose the WTO challenge, dragging out the case still helped domestic firms. Second, some of the challenged measures turn out to be not very effective at achieving their intended aims, so they are dropped when they become more trouble than they are worth. Third, protectionist tactics are not always universally popular within China, and some domestic lobbies make common cause with outsiders pushing a WTO case. A good example is the case on financial information services, where the state's Xinhua news agency stood to gain from rules giving it a dominant position, but domestic financial institutions and other information providers would have suffered, and their concerns were heard loud and clear.

### **No more small fry**

This pattern is instructive for ongoing disputes. In July, a WTO panel issued a mixed ruling on a case challenging the strong position the state-sponsored association China UnionPay has in China's market for electronic payments and bank cards. The panel found that UnionPay is not officially a monopoly, but that competitors including Visa and MasterCard do face an unreasonable disadvantage in China. China opted not to appeal the decision, so we should expect it to grudgingly open this market. Domestic banks and other financial service providers, not to mention consumers, are not thrilled about paying high fees to UnionPay and will be happy to see more competition.

Similarly, we expect China will eliminate the restrictions on exports of raw materials, including bauxite, coke, fluorspar, and magnesium, that were successfully challenged in another recent case. If China also loses the current case on its limits on rare earth exports—a likely outcome given that the issues are very similar—it will also comply. The policies at issue may have helped local producers of those commodities, but it is far from clear that they have met broader industrial policy goals like strengthening downstream domestic producers or inducing foreign high-tech companies to relocate to China. So they can be sacrificed.

Ultimately, the trade issues that China has been challenged on at the WTO have not been politically and economically important enough for it to openly defy international trade law. As the world's largest exporter, it has an interest in ensuring everyone respects the rules of global trade. But this may not be the case forever: as China's industries move up the value chain, they are becoming more direct competitors with those in the US and EU. It is not impossible that China could become locked in a tit-for-tat struggle of dueling WTO cases over a politically important industry, analogous to the one between the US and EU over Boeing and Airbus. Neither side has yet fully accepted the WTO's decision in that case, leaving global trade's traffic cop standing futilely by.

This prospect got more likely last week, when the US challenged China's support for its auto industry, and China responded with a challenge to a US law on the anti-subsidy duties often applied to Chinese goods. So far the WTO has been able to serve as a dispassionate arbiter between China and its trading partners, but this workmanlike atmosphere could be tested by a wave of more politically charged cases.