

CURBING STATE-DRIVEN TRADE POLICIES: HOW TO CRAFT NEW & EFFECTIVE APPROACHES TO COUNTER DISTORTIVE PRACTICES

A Summary of November 2019 & May 2020 Asia Society Policy Institute Roundtables

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July 2020

I. INTRODUCTION

Trade tensions between the United States and China have been growing exponentially in recent years. While the U.S.-China phase one trade agreement, signed in January 2020, addressed some areas of friction, the matters at the heart of the conflict — industrial subsidies, the behavior of state-owned enterprises (SOEs), and the overall role of the state in the Chinese economy — remain unresolved. The United States is not alone in its concerns; other countries have expressed similar grievances. Work is underway in academia, think tanks, and international organizations — including the Organization for Economic Cooperation and Development (OECD) — to examine the policies that contribute to overcapacity, unfair competition, and market access barriers, affecting home markets and third countries.

Against this backdrop, the Asia Society Policy Institute (ASPI) convened two roundtable discussions in November 2019 and May 2020 to delve deeper into these challenges. Participants included congressional staff, embassy officials, current and former government officials, corporate leaders, and trade experts. Ken Ash, the OECD's Director for Trade and Agriculture, was the featured speaker in November 2019, when he presented the OECD's work on subsidies, focusing on its recent aluminum and semiconductor sectoral reports. At the May 2020 roundtable, Professor Mark Wu of Harvard Law School, a former official in the Office of the U.S. Trade Representative, led the discussion, focusing on systemic differences between the Chinese economic model and those of other developed countries, as well as ways that international rules could be strengthened on subsidies and other trade-distorting state involvement in the economy.

The following is a summary of those proceedings, along with key findings that emerged from the roundtable discussions. Attribution has been removed to respect the Chatham House rules on these convenings.

This project was made possible by the generous support of the Alcoa Foundation.

II. MEASURING MARKET DISTORTIONS — THE WORK OF THE OECD

In recent years, the OECD has sought to model and quantify the modern trade landscape and the impacts of different forms of government support that can lead to “market distortions.” These distortions have been observed in several sectors, including aluminum and steel. Even as global prices have fallen and profit margins have narrowed, firms in these industries — frequently state owned or state invested — have continued to invest in new capacity and increase production. This phenomenon, commonly referred to as “overcapacity,” raises concerns about non-market forces driving production, with negative consequences for the global economy.

Mr. Ash presented the OECD report [Measuring Distortions In International Markets: The Aluminium Value Chain](#) (referred to as the “Aluminum Report”). Published in January 2019, this report aimed to capture the range of government support — both direct and indirect, at all levels of the value chain — that contributes to overcapacity in this important sector. Key takeaways from both the report and the presentation of it to the roundtable include the following:

- **Lack of transparency is a major issue.** Understanding the problem is difficult when data on the range of existing support is opaque or unavailable. At times, the OECD had to conduct primary research, using of satellite imagery to capture the scale of aluminum capacity accurately.
- **Non-market forces are also at work.** When examined closely, the data shows that some firms have invested and increased production, even as prices have fallen and profits have disappeared.
- **Below-market financing is important and hard to measure.** While subsidies in the form of direct government transfers remain common, a major channel for government support is the provision of financing (i.e., loans, bonds, etc.) at below-market rates. This support can be hard to measure.
- **Levels of support are surprising, as is the role of SOEs.** When the broad range of subsidizing policies was captured, the OECD found that the level of support was quite high. This held true even when the OECD used conservative estimates, which likely understated the real level of support. Researchers were surprised to see that SOEs behaved both as beneficiaries of support (i.e., as recipients of subsidies) and as suppliers of support (i.e., providing cheap inputs or financing to downstream producers), a phenomenon that Professor Wu discussed at the second roundtable.

Building on this work, Mr. Ash previewed the OECD’s latest research on the semiconductor sector, which was published in the December 2019 report [Measuring Distortions In International Markets: The Semiconductor Value Chain](#) (referred to as the “Semiconductor Report”). This report identified more and different types of distortions than the Aluminum Report. These distortions were highlighted by the OECD officials who participated in the second ASPI roundtable:

- **Equity infusions are distorting and hard to quantify.** Government support through equity stakes in firms can also distort markets. This support is hard to measure, as it can provide both a “one-off” cash infusion from the equity purchase and

ongoing support, including tolerance for below-market returns. Support in the form of equity infusions is particularly prevalent in the semiconductor industry, and it is especially pronounced in China.

- **It is necessary to look beyond “ownership.”** The traditional focus on state ownership often understates the level of government influence. The distortions are less an issue of wholly government-owned enterprises than “state-invested enterprises” (SIEs) and firm behavior. In China, boundaries between SOEs and SIEs are not always clear. The OECD participants and Professor Wu noted that political connections can matter as much as state ownership when it comes to securing financial or regulatory assistance. Looking at the composition of a company’s board, or how it is appointed, can be as useful as monitoring the state’s official ownership stake.
- **Global value chains also muddy the picture.** With connected global value chains, it is less clear who is the ultimate beneficiary of support. Likewise, support can build along the value chain: for example, the OECD found that in the global aluminum value chain, state support at the smelting stage ultimately benefited downstream producers of fabricated aluminum products. This can make it difficult to target such support with existing disciplines.

III. AN EYE ON TOMORROW — FUTURE WORK OF THE OECD

The first roundtable’s participants proposed a variety of areas in which the OECD could add value:

Examining New Sectors

Certain participants suggested that the OECD pursue similarly comprehensive research on other sectors. Of particular interest were those sectors targeted by the Made in China 2025 initiative, such as robotics, new energy vehicles, and next-generation information technology. One participant suggested solar panels for investigation, as it would offer a useful case study in market distortions contributing to beneficial outcomes in the form of spurring adoption of renewable energy.

Crosscutting Investigation

The roundtable supported an examination of specific policy instruments across a range of sectors. For example, building on the Semiconductor Report, an investigation of the impact of equity infusions by governments in a variety of sectors, including low- and high-tech manufacturing, could provide valuable insights into the effects of these practices on markets.

Likewise, some participants suggested expanding the scope of research to look not just at policies that lead to overcapacity but also at policies used to *maintain* overcapacity.

Holistic Approach to Range of Policies

One striking lesson of the Aluminum and Semiconductor Reports is the importance of looking not only at specific policies but at the interplay of those policies. For example, the Aluminum Report noted how export restrictions on “upstream” (i.e., early in the value chain) production artificially lowered the prices of inputs, which, combined with rebates on value-added taxes (VATs) for exports of “downstream” aluminum production, helped boost international competitiveness. Looking at only one of these policies would not sufficiently capture the full level of support. Further research examining how policies combine to distort markets could advance understanding of these issues.

Ongoing Research and Updating Reports

Discussants suggested ongoing research to provide periodic updates on the status of specific sectors or practices. In particular, participants expressed interest in research on countries’ progress (or lack thereof) on reining in distorting policies. Others proposed using the OECD peer-review mechanisms, along with the Trade Policy Review process of the World Trade Organization (WTO), to promote consistent monitoring.

IV. THE UNIQUE NATURE OF THE PROBLEM: CHINA, INC.

At the May 2020 roundtable, Professor Mark Wu discussed the specific challenge of addressing Chinese practices using a playbook designed for “any other major economy.” In his view, tensions with other trading partners are quite different from those with China. The structure of the Chinese economy means that its clash with the United States, as well as with the broader international trading regime, sometimes is not a result of tangible, substantive issues but of frictions between overall systems of political and economic organization.

Other participants noted that most of the global rules for disciplining subsidies reference the state or government, but a key feature of China’s system of industrial subsidies and SOEs is that subsidies often flow indirectly, through informal responses to Communist Party directives, rather than through official government bodies. Professor Wu has addressed this in several of his publications by referring to the “[party-state](#).” He noted that this is an important loophole in the existing rules when it comes to addressing China’s industrial policies.

According to Professor Wu, China’s economic structure is tied to its overall political goals, which results in informal, hard-to-track mechanisms of control and assistance that sometimes do not flow through the state. He noted that this structural challenge is “evolving.” Professor Wu argued that one of the core disadvantages of the global approach to combating it is that the prescribed responses are based on the way the global rules were outlined in the General Agreement on Tariffs and Trade and in China’s WTO accession talks. Because the state-led nature of the Chinese economy is dynamic, the negotiators of those agreements could not envision the modern form of China’s state involvement. Professor Wu called the Chinese system “nimble” and stressed that even new rules that could be agreed upon might not address the challenge if they take several

years to come into effect, while the Chinese system continues to evolve during that period.

Some of the complaints about China's practices mirror those levied at Japan in the 1980s. But his point about China's overall political system, and the fact that China today is a geopolitical competitor with the United States, highlight the differences with that era; Japan never was a geopolitical rival. A multidisciplinary approach that combines both economic diplomacy and geopolitics will be needed.

V. COMPLICATIONS OF COVID-19

The impact of the COVID-19 pandemic was also a topic of discussion at the May roundtable. Certain participants noted that stimulus and other government programs associated with the economic fallout of the pandemic could complicate the effort to address these practices by increasing the state's role in economies around the world, in both the developed and the developing world.

Even though these two types of government assistance are quite different with respect to their time frames and objectives, seasoned negotiators know that when they head into trade talks with defensive concerns, they may be less successful in advocating for new rules because their hands are less clean. Countries may thus have less policy space to push for new rules after launching large stimulus packages, including targeted interventions, in several economies. Countries that have been frustrated with Chinese subsidies could be in violation of the rules they constructed to attack those very subsidies. Imagine, for instance, if the United States or a trading partner were to bail out aluminum or semiconductor firms in the event that they were hit especially hard by the pandemic—how might China respond?

Some participants at the roundtable suggested the United States and like-minded partners should greenlight certain interventions or subsidies in exchange for stronger disciplines for those that are more distortive. This could, in theory, allow more spending during the COVID crisis without undercutting the push to rein in subsidies. It could also help get the buy-in of Chinese negotiators by offering to make some of their practices explicitly legal. One participant suggested this could be an avenue for future trilateral talks.

VI. RUBBER MEETS THE ROAD — TURNING RESEARCH INTO ACTION

ASPI convened the roundtables amid a debate about how the world’s trading system could counter Chinese practices, and even amid some claims that the United States, the European Union (EU), Japan, and like-minded partners should seek a major “decoupling” of their economies from China. Yet the majority of roundtable participants believed these countries must find a way to coexist with China’s economic system and that bolstering international rules was the best path forward. As U.S. Trade Representative Robert Lighthizer, an avowed China hawk, said recently, “We have an American system, and we have a Chinese system. And we’re trying to figure out a way to have these two become integrated.”

Both roundtables highlighted the imperative for governments to use research and data, such as that gleaned from the OECD’s studies, as a basis for updating international rules. The group outlined several possible approaches, noting that none is without serious shortcomings.

- *Using the WTO Dispute Settlement System*

While some participants suggested that more WTO dispute settlement cases against Chinese unfair trade practices could be useful, Professor Wu described the system as “broken” because of the current Appellate Body impasse. This impasse, he noted, arose out of long-standing U.S. complaints predating the Donald Trump administration.

He also referred to a “remedies gap”: even if a country were to win a case against China at the WTO, China would still get a “free pass” for its illegal act because it would not have disgorged the economic gains obtained during the years it took to discover the breach and litigate the case.

Participants also discussed the WTO’s evidentiary burden for plaintiffs. The *China, Inc.* model, in which state ownership is difficult to prove and networks of influence are informal, often makes it difficult, if not impossible, to satisfy the evidentiary requirements of dispute settlement cases.

- *Negotiating New Rules in the WTO*

Others expressed strong skepticism that the WTO could even serve as the venue for future negotiations on new rules to counter subsidies and other forms of state aid, in light of the difficulty in reaching consensus among its 164 members.

Furthermore, even if the WTO *could* negotiate new disciplines under the Agreement on Subsidies and Countervailing Measures, such as designating below-market equity infusions as a “subsidy,” it would not fully address the other policies that contribute to the problem, and government support would likely shift to new forms.

- *Ad Hoc Rules-Based Approaches, Such as the Trilateral Group*

The progress of the trilateral group of the United States, the EU, and Japan was applauded by participants for working toward a shared understanding and building support for proposals to address the challenge. However, participants emphasized that even among this group of countries, differences remain over the level of ambition. Despite this, participants suggested that the trilateral work, and particularly the list of proposed WTO rule changes from the trilateral group in early 2020, could form a starting point for further negotiations.

However, the roundtable participants also outlined several clear weaknesses of the trilateral approach, most notably, the fact that it would need to entice the buy-in not only of China but of other countries as well. Many were skeptical that the trilateral group would be able to press others into accepting these rules.

- *Plurilateral Negotiations on Specific Sectors*

Participants suggested that a plurilateral negotiation, aimed at setting stronger rules among willing countries, would best serve the goal of addressing state-led economic policies, given their complexity. Participants at the first roundtable discussed whether these could be facilitated by the OECD, as the Global Forum on Steel Excess Capacity has done, or separately among the OECD members and perhaps additional countries.

- *TPP-Like Approaches*

Participants at the second roundtable also discussed confronting economic practices by combining several plurilateral or other ad hoc coalitions of trading partners into larger blocs so that it would be in China's interest to adhere to their rules. Professor Wu suggested that coalitions such as the Trans-Pacific Partnership (TPP) could be effective if the goal is to move supply chains from China. But if the goal is to change practices around Chinese industrial subsidies or the behaviors of Chinese SOEs, building coalitions by itself is not an effective tool.

- *No Silver Bullet*

The group acknowledged that that no single approach will be sufficient to address the issues of state-led economies, and policymakers will need to be adaptable and utilize a comprehensive toolbox of responses. Some thought this toolbox should include unilateral measures, such as tariffs, given the long time frame for most negotiations. Certain participants asserted that countries should not be expected to sit idly as distortions take place, but these measures should be done in parallel with international cooperation whenever possible, and leverage resources such as the OECD to build an empirically based argument.

VII. KEY FINDINGS OF THE TWO ROUNDTABLES

To summarize, the following findings emerged from the two roundtables to guide policymakers:

- **Transparency is a vital first step.** It is difficult to establish disciplines on state-led economic policies and practices without a shared understanding of the problem. The work of the OECD has shined a light on the level and complicated nature of industrial subsidies, the behavior of SOEs, and other forms of government support.
- **OECD and related work must be publicized.** The impact of work by the OECD and other institutions will be limited if it is left in the shadows. Policymakers, along with stakeholders in the private sector, think tanks, and academia, should help publicize these studies.
- **Research and evidence should spur policy action.** Although they provide valuable insights, research papers are not enough. This research should be used to spur action toward addressing the problem, including through negotiations on rules and disciplines.
- **But combating these issues will not be easy,** Rules cannot simply be written at the WTO that address these problems. Instead, countries need a multifaceted, all-of-the-above type of strategy that includes rewriting WTO rules, as well as plurilateral arrangements and perhaps even TPP-like regional coalitions. The challenge will be too complex for a silver-bullet solution.
- **Chinese buy-in is difficult but necessary.** While China is not alone in its trade-distorting practices, the data shows it is a singular contributor to overcapacity. For any disciplines on the role of the state to be effective, Beijing must be convinced that it is in China's ultimate interest to reform these practices. Some participants suggested coming up with capacity-reduction commitments in relevant sectors that would not require China to disavow its economic model but still would alleviate the pressure in global markets. They envisioned this as "low-hanging fruit" that could allow China to take some credit for reductions and provide a vehicle for further, more difficult reforms.
- **COVID-19 may lead to more state involvement in global economies, complicating work to discipline Chinese practices.** Subsidies and other types of financial assistance may proliferate as countries look to prop up industries that are struggling because of the pandemic.