How WTO Dispute Settlement Can More Effectively Address Overcapacity

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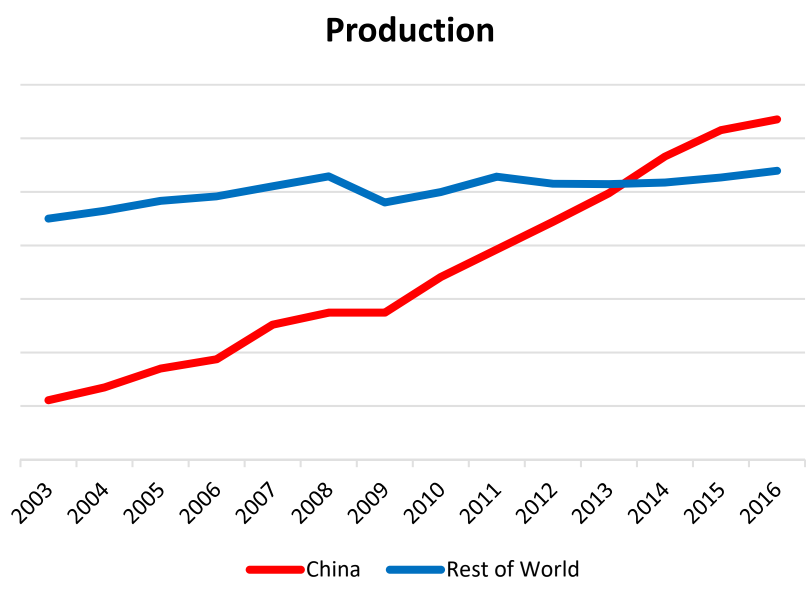
Background: The Overcapacity Problem

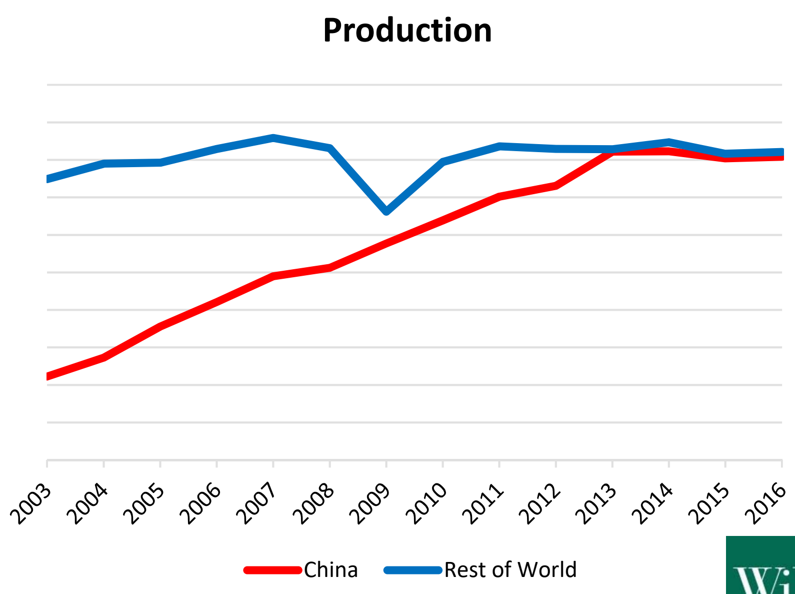
- The overcapacity numbers are staggering:
  - Steel – as much as 350 million tons, almost five times total U.S. production in 2016
  - Aluminum – as much as 9 million tons, more than 10 times U.S. production in 2016

The Cause: Massive Increases in Chinese Production …

Aluminum



Steel



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…. That Are Not Marked-Based

- "Blind expansions," to quote the Chinese government, have occurred despite:
  - Falling prices
  - Poor firm performance
  - Lack of comparative advantage, especially in aluminum
- Why?

Money Flows through the State-Directed Financial System

- The government ensures virtually limitless financial support through the state-owned and -directed financial system
- This includes formal bank lending, bond markets, equity infusions, etc.

"China's commercial banks . . . are still expected to support policy objectives and align their strategies with the State's broad economic goals, and are frequently urged to do so. This suggests China remains a centrally planned economy despite financial reforms and effort at rebalancing the economy that had implied a greater role for market forces."

Fitch Ratings (2016)

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Lavish Financing Despite Abysmal Financials

Financial Ratios of Major Aluminum Producers Show They are not Creditworthy

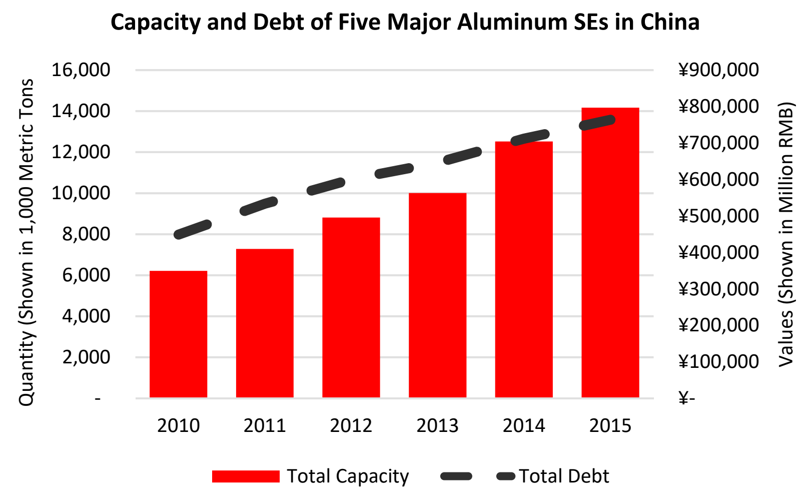
Aluminum Corp. of China (CHALCO)								
Ratio	2008	2009	2010	2011	2012	2013	2014	2015
Current	1.105	0.908	0.742	0.801	0.585	0.652	0.609	0.793
Quick	0.588	0.398	0.351	0.415	0.280	0.409	0.394	0.544
Debt-to-Equity	1.251	1.410	1.471	1.702	2.255	2.715	3.861	2.763
State Power								
Ratio	2008	2009	2010	2011	2012	2013	2014	2015
Current	0.264	0.302	0.326	0.390	0.387	0.373	0.356	0.423
Quick	0.205	0.229	0.240	0.280	0.271	0.275	0.268	0.337
Debt-to-Equity	4.597	10.180	5.602	6.059	5.494	5.443	5.331	4.680
Shenhuo								
Ratio	2008	2009	2010	2011	2012	2013	2014	2015
Current	0.491	0.560	0.684	0.606	0.521	0.495	0.500	0.497
Quick	0.388	0.425	0.513	0.456	0.403	0.346	0.345	0.347
Debt-to-Equity	2.681	3.099	3.348	3.679	3.379	3.650	4.628	5.767
Jiquan Iron & Steel Co. (JISCO)								
Ratio	2008	2009	2010	2011	2012	2013	2014	2015
Current	1.351	0.954	1.192	0.861	0.705	0.730	0.655	0.334
Quick	0.730	0.532	0.744	0.569	0.446	0.452	0.452	0.213
Debt-to-Equity	1.904	1.656	1.743	2.610	2.632	1.969	2.180	2.656
China Hongqiao Group Limited								
Ratio	2008	2009	2010	2011	2012	2013	2014	2015
Current		0.468	2.363	1.507	1.231	1.024	0.887	0.777
Quick		0.377	1.824	1.242	0.973	0.549	0.486	0.487
Debt-to-Equity		2.618	0.828	0.613	0.987	1.425	1.570	1.937

- Lending covers both operating losses and expansion of state enterprises, some of which operate below variable costs
- Profits have been created using asset sales to the government and related entities to avoid delisting
- Actual financial performance may be worse than it looks…

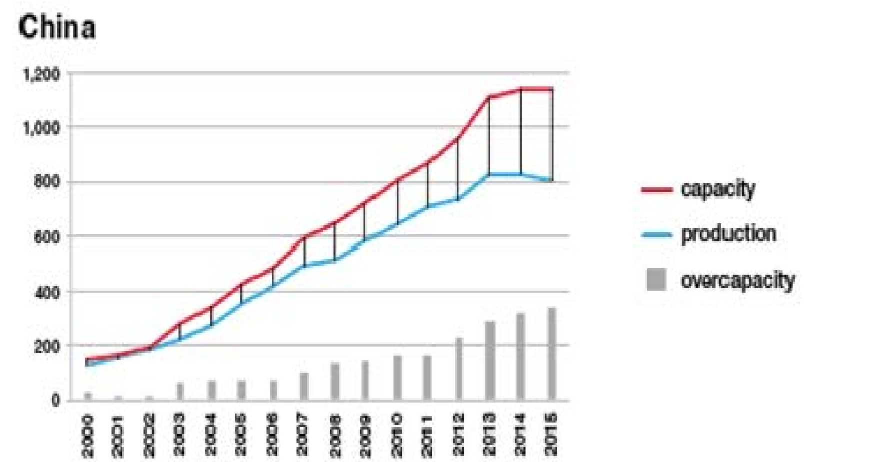
Debt Fuels Blind Expansions

“Credit allocation has also been driven in large part by continued financing to non-viable companies in industries with over-capacity.”

USDOC (Aug. 1, 2017)



Source: CRU; Company Financial Statements



Note: figures represent nominal raw steelmaking capacity, production and overcapacity in million metric tons (MT) across the major steel producing regions in the world. Please note the difference in scale for China and all other regions.
Source: Duke CGGC, calculated from the German Steel Federation (capacity) and World Steel Association (production).

Finance isn’t the Only Problem

- Providing inputs at less than adequate remuneration (LTAR) compensates for the fact that in many of these industries, China has no natural competitive advantage.
- For example, in the context of aluminum, access to low-cost energy is critical, China is by far the high-cost producer in this regard yet it possesses 56% of total global capacity. The LTAR’s the United States has alleged on coal, electricity and alumina compensate for this comparative disadvantage.
- The provision of goods at LTAR permits these companies to operate uneconomic capacity, and to build yet more uneconomic capacity.

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The SCM Agreement Provides the Tools to Tackle this Problem

- The Agreement defines “subsidy” broadly:
  - Covers contributions by governments, public bodies, and private entities acting as governments would
  - Covers direct funding and revenue foregone
  - Covers contributions other than funding
- And contemplates a range of targeted entities:
  - Individual firms
  - Groups of firms
  - Industries

Tools, Continued…

- It also covers a broad scope of adverse effects:
  - Injury;
  - Nullification or impairment; or
  - Serious prejudice.
- Serious prejudice is itself broad, covering:
  - Displaced or impeded imports or exports;
  - Price undercutting, price suppression, price depression, or lost sales;
  - Increased market share.

The U.S. consultation request shows how these provisions cover overcapacity in aluminum, for example:

- Loans
- From public bodies
- At far-below-market rates for non-creditworthy companies
- Directed at the aluminum industry
- Causing price depression and suppression (and increased market share for the subsidized companies)

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Building a case, however, is difficult and time consuming

- In the meantime, overcapacity destroys industries in other WTO member states. Subsidy challenges should be streamlined so that the problem can be addressed more quickly.
- There is precedent in the existing SCM Agreement:
  - For example, prohibited subsidies do not require a showing of adverse effects.
  - The reporting requirements of subsidies under Article 25 could be enhanced.

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Possible Solutions

The most basic solution begins with perception….

- Respect the use of trade remedies.
  - The WTO and the DSB have been criticized for appearing to have an inherent bias towards trade remedies, at times calling correcting measures “trade restrictive” or “protectionist.”
  - The WTO’s trade monitoring report divides the world in two -- trade-facilitating and trade-restrictive measures – and notes that the report’s purpose is to shed light on protectionism asserting that the report does not characterize trade remedies as protectionist.
  - Trade remedies are not “protectionist,” they are intended to correct the effects of unfair trade practices of one member on another.

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The Continued Erosion of Trade Remedies Compounds the Problem

- By inappropriately applying the standard of review in many cases and reading obligations into the SCM agreement that do not exist in the text, the DSB has hampered the effectiveness of the SCM Agreement in tackling systemic problems such as the overcapacity crisis.
- The erosion of Members' ability to use trade remedies creates a moral hazard – and encourages Member states and their companies to engage in unfair trade.
  - Recent decisions on public bodies and entrustment and direction complicate the ability of the SCM Agreement to address systemic problems.
  - The causation requirements articulated in examining "serious prejudice" are not found in the language of the agreement – "genuine and substantial relationship."

Eroding Trade Remedies Has A Chilling Effect on Claims Under Other Parts of the SCM Agreement

- Provisions between the various parts of the Agreement overlap (*e.g.*, public body). When the DSB adopts interpretations that undermine trade remedies proceedings, the DSB creates the perception that it will likewise be hamstrung if examining those provisions in response to affirmative subsidy claims before it.
- This feeds a perception that the WTO is not equipped to address modern cheating and why there is a need to “amend” the SCM Agreement to better address these types of systemic overcapacity problems.

#1 -- Excess Capacity Should Be Expressly Identified In The Agreement

- Add a new paragraph to Article 5 that establishes a finding that a subsidy causes serious prejudice where:
  - The subsidy is specific; and
  - A Member's capacity levels of a particular like product over a period of time have suppressed and/or depressed prices of another Member's like product.

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#2 – Bring Back Article 6.1

- Similar to the first proposal, reviving Article 6.1 would also help to more efficiently address the adverse effects of the types of subsidies leading to excess capacity.
- At the time of China's Accession Art. 6.1 had already lapsed, but reviving it would still require agreement by other Members.
- Article 27.8 – rebuttable presumption for developing Members, does not inherently make this provision less effective.

#3 – Below Market Financing Should be Prohibited

- As we have shown, one of the principal mechanisms for subsidizing overcapacity is below-market financing schemes
- As such, Article 3 should be amended to include below-market financing schemes as prohibited subsidies.
  - This provision should prohibit the most extreme forms of government economic intervention by providing financing to uncreditworthy companies.

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Solution #3, continued....

- Article 3.2 would be amended to include:
  - (a) direct transfer of funds to cover operating losses;
  - (b) Forgiveness of debt (taking into account bankruptcy laws or other insolvency proceedings);
  - (c) Loans to enterprises that are uncreditworthy; and
  - (d) Debt-for-equity swaps that are not on commercial terms.

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Solution #3, (creditworthiness) continued ….,

- In examining creditworthiness, there would need to be some consideration of:
  - Present and past financial indicators and stress-test ratios;
  - The enterprise’s recent and past present ability to met its costs and fixed financial obligations with cash flow;
  - Evidence of the enterprise’s future financial position, such as market studies, country and industry economic forecasts, project and loan appraisals;
  - Value of collateral or guarantee provided on commercial terms to secure the loan.
    - The mere existence of private lenders in the overall lending package in itself shall not be dispositive of the creditworthiness of the enterprise.

Solution #3 (equity worthiness), continued … ,

- In examining whether a government's provision of equity capital is provided on commercial terms, the following factors shall be considered:
  - Objective analyses of the future financial prospects of the recipient enterprise or project as indicated by, inter alia, market studies, economic forecasts, and projected or loan appraisals prior to the infusion;
  - Current and past indicators of the recipient enterprise's financial health;
  - The enterprise's rates of return on equity in the three years prior to the government infusion; and
  - Whether the enterprise is itself a state-owned enterprise and the degree to which that state-ownership provides an implicit guarantee of return.

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Solution #3 (presumption) … ,

- It shall be presumed that subsidies provided in new Article 3.2 have adverse effects on capacity, production, and sales of the recipient.
- Exclusions for certain types of financial subsidies:
  - Small business programs;
  - Subsidies for war materials and goods for national security and defense purposes.

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#4 – Proposed EU Amendment to Art. 3

- (a) subsides granted under any legal agreement to cover debts or liabilities; and
- (b) subsidies (such as loans and guarantees, cash grants, capital injections, provision of assets below market prices or tax exemptions) to insolvent or ailing enterprises, *without a credible restructuring plan* based on realistic assumptions with a view to ensuring the return of the insolvent or ailing enterprise within a reasonable period of time to long-term viability and without the enterprise significantly contributing itself to the cost of the restructuring.

#4 – EU Proposal Continued …

- The “without a credible restructuring plan” appears to make this proposal much less effective in dealing with the overcapacity crisis.
- The main cause of the capacity crisis is the continued financing of firms that should otherwise have exited the industry. Allowing for restructuring has the potential to undermine the ability to effectively address the problem, especially in China where there are no functioning bankruptcy laws.
  - In 2016, Hongqiao – a private company - was in danger of default on its debt. It was bailed out by CITIC and is now essentially an SOE;
  - In 2013, Chalco sold RMB 5 billion in assets to its parent, Chinalco, to avoid delisting after three consecutive years of losses; and
  - Chinalco recently suspended A share trading, suggesting movement on a rumored reorganization involving State Power Investment Co.

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#5 -- The provision of inputs should also be prohibited

- As discussed, LTAR subsidies also contribute to the excess capacity crisis.
- Government's often provide key inputs at preferential rates to preferred sectors of the economy such as raw materials, water, electricity, gas, land etc.
- Amend Article 3.1(b) to align with national treatment provisions of GATT Article III to prevent the government from favoring domestic inputs over imports.
- Currently Article 3.1(b) requires an absolute obligation, it should be amended to also include encouragement or inducement to favor domestic inputs.
  - Government ownership and influence over raw material production should be covered by this provision to induce of favor domestic inputs

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#6 – Increased Transparency Requirements

- The requirements to report subsidy programs should be strengthened under Article 25 to encourage greater transparency.
  - Members flout their obligations to notify their subsidy programs. Currently, there is no penalty for doing so.
  - Members who fail to notify their subsidy programs should be precluded from filing claims under the SCM – including claims arising under Part V.
  - It stands to reason that if a Member is withholding information about its subsidized programs, that Member should not be able to challenge affirmative subsidy findings by others.
  - In addition, if a Member fails to notify a subsidy, and another Member demonstrates that the subsidy exists based on the information reasonably available, it shall be presumed that the particular subsidy is actionable under the SCM Agreement.
  - Members should also be required to report their ownership positions of an enterprise by either the government or public body.

#7 – Strengthen the Annex 5 Procedures

- Preparing and presenting a challenge to systemic excess capacity and its adverse effects requires an enormous amount of information to present an affirmative case.
- While Annex 5 procedures allow Members to gather additional information that may not be reasonably available to support their claims, these procedures are limited.
- The DSB should consider creating questionnaires designed to gather information from both the Member and the Member's enterprises producing the domestic like product that is the subject of the claim.
- The DSB has been handling greater amounts of proprietary information, there is no reason Annex 5 procedures cannot be modified to allow greater information gathering.

#8 – Specific DSB Decisions Should Be Clarified And/Or Reverse in Revised Language

- Reverse the DSB decisions that have undermined the operation of the SCM. For example:
  - *US – Antidumping and Countervailing Duties* (China) DS 397: The DSB has created an imprecise definition of "public body" that has fueled confusion and debate over when an entity is a public body.
  - The agreement should amend the definition of public body to clarify that state ownership of production assets can qualify as a public body. Public bodies in this sense must be understood to be broader than an entity exercising a "government function."
  - This interpretation does not comport with practical and commercial reality when dealing with mercantilist command economies like China, and it makes properly considering the provision of LTARs more difficult.

Questions?

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