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WHY INVOKING THE SCM AGREEMENT MAY NOT BE A GOOD RESPONSE TO CHINESE TEXTILES

Konstantina K. Athanasakou†

I. Introduction

The global trading system faces one of its most serious challenges with the threat of China dominating the global textiles market as a result of the World Trade Organization (“WTO”) textile quota expiration.¹ Textile import quotas terminated on January 1, 2005, as required under the WTO Agreement on Textiles and Clothing (“ATC”).² Faced with the Chinese “800-pound gorilla,”³ the United States and other developed countries are currently looking for ways to foster competitiveness in their domestic textile and apparel industries.⁴ In addition, several developing countries have raised concerns to the WTO that the elimination of textile quotas will stifle their economic development.⁵

On the other hand, the People’s Republic of China (“China”), which joined the WTO in 2001,⁶ struggles with cooperating and functioning within the world trade regime. Accused of subsidizing its textile and apparel industries,⁷ the Chinese government, as a good faith gesture, imposed a new tariff on local textiles on

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¹ David Barboza & Elizabeth Becker, *China Rides New Surge In Export of Textiles*, INT’L HERALD TRIB., Mar. 11, 2005, available at http://www.ihf.com/bin/print_ipub.php?file=/Articles/2005/03/10/business/trade.html; William R. Hawkins, *The Geopolitical Challenge of Chinese Textile Exports*, 5 CHINA BRIEF 8 (Apr. 12, 2005), available at http://www.jamestown.org/images/pdf/cb_005_008.pdf.

² Agreement on Textiles and Clothing, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, Legal Instruments—Results of Uruguay Round, 33 I.L.M. 1125 (1994) [hereinafter ATC].

³ See William Pesek, Jr., *China is Global Economy’s 800-pound Gorilla*, THE MANILA TIMES, May 25, 2004, available at <http://www.manilatimes.net/national/2004/may/25/yehey/business/20040525bus7.html>.

⁴ See generally William C. Sjoberg & Carlos Moore, *China Textile Safeguard: Process Effect*, Textile World (2004), <http://www.textileworld.com/News.htm?CD=2732&ID=8219> (examining current United States trade considerations regarding imposing safeguards as a response to the threat of Chinese textiles import surge); see also Global Alliance for Fair Textile Trade (GAFTT), *Global Alliance Presses Governments and WTO to Halt Chinese Monopolization of Global Trade in Textiles and Clothing*, (Jan. 26, 2005), <http://www.amtacdc.org/pdf/050126gaftt.pdf> [hereinafter GAFTT].

⁵ Daniel Pruzin & Christopher S. Rugaber, *Textiles: WTO Members to Continue Talks on Proposal to Examine Global Quota Elimination Impacts*, 21 INT’L TRADE REP. 1620 (2004), available at <http://www.bna.com/itr/arch266.htm>.

⁶ WTO Accession of the People’s Republic of China, WT/L/432 (Nov. 23, 2001) [hereinafter Accession Agreement].

⁷ U.S.-CHINA ECONOMIC & SECURITY REVIEW COMMISSION, 2004 REPORT TO CONGRESS, 108th Congress, at 264 (Jun. 2004), http://www.uscc.gov/annual_report/2004/04annual_report.pdf (stating that China provides preferential access to loans to its manufacturers) [hereinafter 2004 REPORT]; Jonathan Steiman, *Expiration of Textile Quota Act Takes Toll on U.S. Manufacturers* (Jan. 13, 2005), <http://www.>

January 1, 2005.⁸ Further, the provisions of China's WTO Accession Agreement allow for the imposition of limited safeguard measures to protect domestic markets from a Chinese textile import surge,⁹ but these measures might not be sufficient to restrain China from taking over the world textiles market.¹⁰ WTO members are now looking at the WTO framework for ways to address the Chinese textile challenge presented with the expiration of the ATC.¹¹ The WTO Agreements provide one possible solution: WTO countries could impose countervailing duties to the subsidized Chinese imports under the Agreement on Subsidies and Countervailing Measures ("SCM").¹²

However, a country's ability to impose countervailing duties on textiles from China under the WTO threatens the trading regime more seriously than the Chinese supremacy in textiles. Such an imposition poses a more substantial threat: the impairment of the WTO free-trade system itself. The principle of comparative advantage lies at the heart of the WTO framework.¹³ WTO countries, which fear China's comparative advantage in textiles, can use countervailing measures to combat that advantage under the guise of attacking subsidies.¹⁴ However, the imposition of countervailing duties to Chinese textiles within the WTO system will seriously undermine the comparative advantage principle, the basic principle upon which the entire free-trade framework lies.¹⁵

This article argues that although the WTO Agreements provide the possibility to impose countervailing duties on subsidized Chinese textiles imported to a WTO country, such countervailing measures can impair the free-trade system itself and should be used sparingly. Part II presents the fundamental economic concept of comparative advantage as it relates to the WTO free-trade system and

inc.com/criticalnews/articles/200501/textiles.html (quoting the representative of the American Manufacturing Coalition accusing China of subsidizing its textile industry).

⁸ Maurizio D'Orlando, *Beijing Imposes Export Levies on Textiles After Export Quotas Are Abolished*, ASIA NEWS, Jan. 7, 2005, available at <http://www.asianews.it/view.php?l=en&art=2284>.

⁹ See Accession Agreement, *supra* note 6, art. 16. (China's Accession Agreement includes a special safeguard mechanism to prevent a surge of Chinese imports that remains in effect until 2013).

¹⁰ Zhou Yun, *China to Gain from Textile Quota Expiry*, CRI Online, Sept. 2, 2004, available at <http://en.chinainradio.cn/1375/2004-9-2/35@148213.htm> ("It is expected that the removal of restrictions will make China the world's leading manufacturer of textiles and clothing by next year. In fact, the World Trade Organization predicts that China alone will account for more than half of the worldwide textile market by then").

¹¹ Daniel Pruzin, *WTO Members Deadlock on How to Address End of Textile Quotas, Pan Turkey's Proposal*, 21 INT'L TRADE REP. 1747 (2004).

¹² See Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, Legal Instruments—Results of Uruguay Round, 33 I.L.M. 1125 (1994) available at http://www.wto.org/english/docs_e/legal_e/24-scm.pdf [hereinafter SCM].

¹³ See *Understanding the WTO: Basics—The Case for Open Trade*, WTO Online, http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact3_e.htm [hereinafter *Understanding the WTO*].

¹⁴ See SCM, *supra* note 12.

¹⁵ Typically, the imposition of WTO countervailing duties would not threaten comparative advantage because countervailing duties are meant to offset trade-distorting behavior. However, the imposition of countervailing duties in this case would distort comparative advantage, because although one can point to some trade-distorting behavior, the injury caused by the Chinese surge of textile and apparel products stems more directly from its comparative advantage and the removal of the trade-distorting textile quotas.

provides an overview of the current concerns of WTO members regarding China's textiles. Part III analyzes the application of the SCM on subsidized Chinese textiles,¹⁶ and discusses the ability of the United States and other WTO members to bring successful SCM actions against China. Part IV examines the implications of imposing countervailing measures on Chinese textiles in light of the comparative advantage principle and the termination of the textile quota system, suggesting that imposing such measures could undermine the entire WTO framework.

II. Comparative Advantage, the Trading System, and the Problem With Textiles

A. Comparative Advantage

Comparative advantage theory lies at the heart of the free-trade system.¹⁷ The WTO is a free-trade institution, predicated on a system of rules dedicated to open, fair and undistorted competition.¹⁸ The WTO embraces the idea that free trade leads to economic growth, which in turn is based on the theory of comparative advantage.¹⁹ The theory of comparative advantage posits that countries prosper first by taking advantage of their assets in order to concentrate on what they can produce best, and then by trading these products for products that other countries produce best.²⁰

The theory of comparative advantage is perhaps the most important concept in international trade theory.²¹ The original idea of comparative advantage dates to the early nineteenth century.²² Adam Smith, in support of free trade, wrote in *The Wealth of Nations*, "If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage."²³ David Ricardo developed the model describing the theory of comparative advantage.²⁴ According to the "Ricardian Model," each country would export goods in which it has a comparative advantage.²⁵ A country has a com-

¹⁶ See generally SCM, *supra* note 12.

¹⁷ See *Understanding the WTO*, *supra* note 13.

¹⁸ *Understanding the WTO: Basics—Principles of the Trading System*, WTO Online, http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact2_e.htm [hereinafter *Principles of the Trading System*].

¹⁹ See *Understanding the WTO*, *supra* note 13.

²⁰ *Id.*; Steven Suranovic, *The Theory of Comparative Advantage—Overview*, Int'l Trade Theory & Pol'y Lecture Notes (1997-2004), <http://internationalecon.com/v1.0/ch40/40c000.html>.

²¹ See Suranovic, *supra* note 20; see generally Robert Howse, *Symposium: The Boundaries of the WTO: From Politics to Technocracy—and Back Again: The Fate of the Multilateral Trade Regime*, 96 AM. J. INT'L L. 94 (2002).

²² See Suranovic, *supra* note 20.

²³ *Id.* (quoting ADAM SMITH, *WEALTH OF NATIONS*, BOOK IV, SECTION II, 12).

²⁴ See DAVID RICARDO, *PRINCIPLES OF POLITICAL ECONOMY AND TAXATION* (Prometheus Books 1996) (1817); see also *Understanding the WTO*, *supra* note 13.

²⁵ See Suranovic, *supra* note 20.

In his example Ricardo imagined two countries, England and Portugal producing two goods, cloth and wine, using labor as the sole input in production. He assumed that the productivity of

parative advantage in the production of a good if it can produce the good at a lower opportunity cost than another country.²⁶ That is, a nation has a comparative advantage in whichever good it sacrifices the least to produce.²⁷ All countries, even the poorest ones, have assets (human power, industrial capabilities, natural resources, financial capabilities, etc.) that they can employ to produce goods and services for their domestic markets or to compete overseas.²⁸ Based on the comparative advantage theory, it follows that a country should specialize and trade in the good in which it is “most best” at producing or the good it is “least worse” at producing.²⁹ And with the stimulus of an open economy and liberal trade policies, a country will experience the economic growth stemming from fair competition.³⁰ The theory of comparative advantage lies at the core of the WTO framework.³¹

Comparative advantage provides the basis for a country’s expectations of benefits from the WTO system.³² The WTO’s creation on January 1, 1995 marked the beginning of a new era in international trade.³³ The WTO Agreements cover goods, services and intellectual property.³⁴ The Agreements include individual country commitments to reduce tariffs and eliminate other trade barriers.³⁵ In this framework, countries expect to experience economic growth from trading at what they produce best.³⁶

labor (i.e., the quantity of output produced per worker) varied between industries and across countries. . . Ricardo assumed that Portugal was more productive in both goods.

Id. He “demonstrated numerically that if England specialized in producing one of the two goods, and if Portugal produced the other, then total world output of both goods could rise!” Then if England trades with Portugal, “both countries could end up with more of both goods after specialization and free trade than they each had before trade. This means that England may nevertheless benefit from free trade even though it is assumed to be technologically inferior to Portugal in the production of the two goods.”

²⁶ See *id.* It is also important to distinguish between comparative advantage and absolute advantage. A country has a comparative advantage in the production of a good if it can produce that good at a lower opportunity cost relative to another country. A country has an absolute advantage in the production of a good relative to another country if it can produce the good at lower cost or with higher productivity. Absolute advantage compares industry productivities among countries. *Id.*

²⁷ See *id.*

²⁸ *Understanding the WTO*, *supra* note 13.

²⁹ See Suranovic, *supra* note 20.

³⁰ See *Understanding the WTO*, *supra* note 13; see also RICARDO, *supra* note 24.

³¹ See *Understanding the WTO*, *supra* note 13.

³² See RICARDO, *supra* note 24; see also *Understanding the WTO*, *supra* note 13.

³³ See *Understanding the WTO: Basics—The Uruguay Round*, WTO Online, http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact5_e.htm (noting that the Uruguay Round, that resulted in the creation of the WTO, brought about the biggest reform of the world’s trading system since the GATT) [hereinafter *The Uruguay Round*].

³⁴ Susan Tiefenbrun, *Free Trade and Protectionism: The Semiotics of Seattle*, 17 ARIZ. J. INT’L & COMP. L. 257, 269-70 (2000); see *The Uruguay Round*, *supra* note 33.

³⁵ See generally Agreement Establishing the World Trade Organization, Preamble (Apr. 15, 1994); see also *Principles of the Trading System*, *supra* note 18.

³⁶ See *Understanding the WTO*, *supra* note 13.

However, the WTO benefits for textile-producing countries are currently in flux because of the expiration of the ATC³⁷ and the resulting uncertainty in the textiles and apparel market. Countries which are best at producing textiles or apparel hope to benefit from the elimination of all quotas with the expiration of the ATC. However, the accession of China into the WTO changed the dynamic between the countries competing in the trade of textiles. The introduction of such a large player in the competition gave rise to fears of a Chinese take-over of the world trade in textiles, especially after the expiration of the ATC.³⁸ Uncertainty regarding the benefits of free trade replaced the initial optimism for economic growth based on the principle of comparative advantage.

B. International Trade in Textiles

Textiles comprise a very significant part of international trade. In 2003, trade in textiles amounted to €395 billion, nearly 6% of world exports.³⁹ The textiles and apparel sector plays a major role in the economies of industrialized countries and is particularly important for developing and least-developed countries.⁴⁰ Not surprisingly, as it was in the former General Agreement on Tariffs and Trade (“GATT”) system, trade in textiles is one of the contentious issues in the WTO.⁴¹

The textiles trade has been the subject of extensive negotiations between trading countries. Until the Uruguay Round, textile and clothing quotas were negotiated bilaterally under the rules of the Multifibre Arrangement (“MFA”).⁴² The MFA provided for the application of selective qualitative restrictions when surges in imports of particular products caused, or threatened to cause, serious damage to the domestic industry of the importing country.⁴³ These restrictions departed from the GATT non-discrimination principle because they specified how much the importing country would accept from individual exporting countries.⁴⁴ The MFA shaped the pattern of production in garment and textiles by binding countries to maximum export quotas for specific product categories.⁴⁵ On January 1, 1995, after seven years of complex negotiations, the MFA was

³⁷ See ATC, *supra* note 2, art. 9 (ATC expired on January 1, 2005, eliminating all quotas in textiles. Consequently, importing countries whose domestic textile industries are threatened by increased imports cannot place quotas to limit imports).

³⁸ Barboza & Becker, *supra* note 1.

³⁹ *Textiles—What’s New*, <http://trade-info.cec.eu.int/textiles/index.cfm> (last visited Apr. 25, 2005).

⁴⁰ See *Textiles—What’s New*, *supra* note 39; Commission of the European Communities, *Evolution of Trade in Textile and Clothing Worldwide—Trade Figures and Structural Data*, 6-7 (Working document No. DG TRADE E.1/12835, 2003); see also K. M. Chandrasekhar, Chairman, ITCB, Presentation at EC Conference on the Future of Textiles and Clothing after 2004, May 5, 2003, available at <http://trade-info.cec.eu.int/textiles/documents/142.pdf>.

⁴¹ *Understanding the WTO: Textiles—Back in the Mainstream*, WTO Online, http://www.wto.org/english/thewto_e/whatis_e/tif_e/agrm5_e.htm [hereinafter *Textiles—Back in the Mainstream*].

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ See Clean Clothes Campaign, *The Phase-Out of the Multifiber Arrangement*, <http://www.clean-clothes.org/publications/04-04-somo.htm> (last visited Apr. 25, 2005).

replaced by the ATC, which set out a ten-year transitional process for the ultimate removal of the quotas.⁴⁶

The ATC was built on the following key elements: (a) product coverage encompassing yarns, fabrics, made-up textile products and clothing;⁴⁷ (b) a program for the progressive integration of these textile and clothing products into GATT 1994 rules;⁴⁸ (c) a liberalization process to progressively enlarge existing quotas (until they are removed) by increasing annual growth rates at each stage;⁴⁹ (d) a special safeguard mechanism to deal with new cases of serious damage or threat thereof to domestic producers during the transition period;⁵⁰ (e) establishment of a Textiles Monitoring Body (“TMB”) to supervise the implementation of the Agreement and ensure that the rules are faithfully followed;⁵¹ and (f) other provisions, including rules on circumvention of the quotas, their administration, treatment of non-MFA restrictions, and commitments undertaken elsewhere under WTO Agreements and procedures affecting this sector.⁵² The ATC and all its market access restrictions terminated on January 1, 2005.⁵³ Therefore, the general rules and disciplines embodied in the multilateral free-trade system now govern trade in textiles and apparel.⁵⁴

Given the importance of textiles for world trade and the entrance into a new era of trade in textiles after the expiration of the ATC, the global textile and apparel industries have legitimate concerns for the future.⁵⁵ The elimination of all quotas raised questions as to whether the smaller national textile industries can compete against larger national textile industries that can more quickly produce and distribute larger quantities of textile products at lower costs.⁵⁶ The main concern of WTO members is that unfair trade practices, like subsidization, will enhance the capabilities of some of the larger textile manufacturing countries.⁵⁷

⁴⁶ See *id.*; see also *Textiles Monitoring Body (TMB)—The Agreement on Textiles and Clothing*, http://www.wto.org/english/tratop_e/texti_e/textintro_e.htm.

⁴⁷ See ATC, *supra* note 2, arts. 1.7 & 2.6, Annex (stating the textile and clothing products to which ATC applied).

⁴⁸ See *id.* arts. 1.5 & 2.6 (noting the goal of increased openness in the textile markets).

⁴⁹ See *id.* arts. 2.13 & 2.14 (enumerating the stages of the agreement and the pertinent growth rates).

⁵⁰ See *id.* art. 6 (providing a safeguard mechanism during the transition period when there is serious damage or threat of serious damage to the domestic industry for like or directly competitive products).

⁵¹ See *id.* art. 8 (noting the establishment of the TMB and its role).

⁵² See *generally id.* arts. 1-2 & 5 (stating the goals, procedures, and administration of the ATC).

⁵³ *Id.* art. 9 (providing specifically that the duration of the ATC will be 121 months and after its expiration the textiles sector will be integrated into the GATT 1994 general framework).

⁵⁴ *Textile—Back in the Mainstream*, *supra* note 41 (noting that the WTO principles of most favored nation and national treatment are applicable to textiles after the ATC expiration); see also *Textile Industry’s WTO Commitments*, CHINA DAILY ONLINE, <http://bizchina.chinadaily.com.cn/guide/industry/industry9-03.htm> (discussing that according to China’s WTO commitments, the average duty of textiles apparel should be reduced by 17.8 percent, 15.2 percent and 11.4 percent respectively from 2002 to 2005).

⁵⁵ Barboza & Becker, *supra* note 1.

⁵⁶ See GAFTT, *supra* note 4.

⁵⁷ See *id.*

This subsidization concern is particularly acute with respect to China.⁵⁸ China joined the WTO in 2001 after extensive negotiations.⁵⁹ WTO members wanted to ensure that China would commit to making changes toward a market economy in order to participate in the free-trade system.⁶⁰ In joining the free-trade system, China committed to the elimination of its subsidies, including subsidies to the textiles and apparel industry.⁶¹

C. Textiles and the China Accession Agreement

The Accession Agreement of China addresses the concerns of the United States and other WTO members with respect to China's WTO accession.⁶² Specifically, Article 16 provides for "Transitional Product-Specific Safeguard Measures."⁶³ These measures are available when Chinese origin imports cause or threaten to cause market disruption to the domestic producers of like or directly competitive products of any WTO member.⁶⁴ A country can impose safeguards only to the extent necessary to prevent or remedy such market disruption.⁶⁵ Also, these measures are limited in duration.⁶⁶ Under this framework, the United States can only apply safeguards to specific textile products renewable annually for three years following a new determination that the market disruption persists.⁶⁷

However, the China Accession Agreement may not address all the potential problems of a domestic industry confronted with a surge of Chinese textile imports. Under the Accession Agreement, an individual country can respond to a disruption of its domestic market by imposing safeguard measures on the imports at issue.⁶⁸ The country must assess (a) whether there is an import surge of a specific textile article, and (b) whether the increased imports of the article in question cause or threaten to cause a disruption of the domestic textile market in like or directly competitive products.⁶⁹ In the United States, in response to the

⁵⁸ *Id.*

⁵⁹ JINGZHOU TAO & DIARMAID O'BRIEN, NON-TARIFF TRADE BARRIERS IN CHINA, xxx-xxxiv, 144 (Sweet & Maxwell Asia 2003); See Thomas Rumbaugh & Nicolas Blancher, *China: International Trade and WTO Accession* (Int'l Monetary Fund, Working Paper No. WP/04/36, 2004), available at <http://www.imf.org/external/pubs/ft/wp/2004/wp0436.pdf>.

⁶⁰ *Id.*; See Hai Wen, *The WTO and China's Objectives as a World Trading Power* (June 1997), <http://finance.sina.com.cn/d/20040611/1307809441.shtml> (describing China's efforts to join the world trade system that led to its accession to the WTO).

⁶¹ See Rumbaugh & Blancher, *supra* note 59, at 8.

⁶² See generally Accession Agreement, *supra* note 6.

⁶³ Accession Agreement, *supra* note 6, art. 16.

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ Michael Hutchinson, Dir. of the U.S. Dep't of Commerce's Office of Textiles and Apparel Michael Hutchinson, Address at the Organization of Women in International Trade January Meeting (Jan. 25, 2005) [hereinafter Hutchinson, Trade Address].

⁶⁷ *Id.*

⁶⁸ See Accession Agreement, *supra* note 6, art. 16.

⁶⁹ *Id.*

expiration of the ATC, the domestic textile industry sought to impose safeguards on increased imports from China.⁷⁰ The U.S. Department of Commerce received many requests and is currently under pressure to impose safeguards on several Chinese textile articles.⁷¹ To further complicate matters, in addressing the requirements for imposing safeguards on textile products, the U.S. Court of International Trade (“CIT”) recently questioned the ability to control Chinese textile imports under the Accession Agreement safeguard provisions.⁷² The CIT held that a threat of market disruption is insufficient to impose safeguards, and instead required a finding of actual market disruption.⁷³ Regardless of what happened on appeal,⁷⁴ the CIT decision reflects the domestic textile industry’s concerns regarding the appropriate reactions to the surge of Chinese textile imports following the expiration of the ATC.

Moreover, China’s questionable progress towards the elimination of its textile subsidies accentuates the uncertainty surrounding China’s role in the world textile market following the expiration of all textile quotas. China’s enormous capacity to produce and distribute textiles, accompanied by suspicion of subsidization, has intensified the fears of other WTO countries about the future of their own domestic industries.⁷⁵ In this setting, developed countries, like the United States, face declining domestic textile industries and limited means under China’s Accession Agreement to protect them against a Chinese “textile invasion.” At the same time, developing countries encounter the possibility of forcing the shutdown of their domestic textile industries, while lacking alternative means for economic development.⁷⁶ Consequently, WTO countries will look for stronger responses to their concerns and the most appropriate place to start is the WTO framework itself.

III. Applying WTO Countervailing Duties to China’s Textiles

The WTO does provide its members with ways to deal with a surge of imported textiles from China. This part will demonstrate that a country alleging subsidization in the form of preferential access to credit may successfully invoke

⁷⁰ Hutchinson, Trade Address, *supra* note 66; *see also* List of 2005 Requests for China Textile Safeguard Action, http://otexa.ita.doc.gov/Requests_filed_by_industry.pdf (last visited Apr. 10, 2005).

⁷¹ *Id.*; *See* Safeguard Category Embargo Information, http://www.customs.gov/xp/cgov/import/textiles_and_quotas/china/safeguard_embargos_article.xml (on January 25, 2005, the United States had in place only one safeguard on socks from China. However, currently there are ten categories of established import restraints on textiles from China).

⁷² *See* U.S. Ass’n of Imps. of Textile & Apparel v. U.S. Dep’t of Commerce, 350 F. Supp. 2d 1342 (CIT 2004).

⁷³ *Id.*

⁷⁴ *See* U.S. Ass’n of Imps. of Textile & Apparel v. U.S. Dep’t of Commerce, 413 F.3d 1344 (Fed. Cir. 2005) (the U.S. Court of Appeals for the Federal Circuit has lifted the preliminary injunction issued by the U.S. Court of International Trade that barred the imposition of new limits on imported textile and apparel products from China. The injunction had prevented the Committee for the Implementation of Textile Agreements (CITA) from considering twelve safeguard petitions filed in 2004 from U.S. textile manufacturers).

⁷⁵ *See* GAFTT, *supra* note 4.

⁷⁶ Pruzin & Rugaber, *supra* note 5.

the provisions of the SCM to address its suspicions of Chinese subsidization. The Chinese textile industry's preferential access to loans may be an actionable subsidy in violation of China's WTO obligations under the SCM.⁷⁷ Consequently, a challenging country could force China to change its unfair trade practices or could impose measures in retaliation for China's failure to abide by its WTO obligations.⁷⁸

A. The SCM Provisions

1. Finding a Subsidy

The SCM Agreement controls the use of specific subsidies and regulates actions countries can take to counter the effects of subsidies.⁷⁹ According to the SCM provisions, a country can use the WTO's dispute settlement procedures to seek the withdrawal of the subsidy or the removal of its adverse effects.⁸⁰ In the alternative, a WTO member can launch its own investigation and ultimately charge an extra duty ("countervailing duty") on subsidized imports that harm domestic producers.⁸¹

Article 1.1 of the SCM defines what constitutes a subsidy. There are three elements that all must be present for a subsidy to exist: (1) a financial contribution (2) by a government or any public body within the territory of a Member (3) which confers a benefit.⁸² Financial contributions for SCM purposes include grants, loans, equity infusions, loan guarantees, fiscal incentives, the provision of goods or services, and the purchase of goods.⁸³ Government and public bodies include not only national governments, but also sub-national governments and public bodies such as state-owned companies.⁸⁴ Determining the existence of a benefit is very clear if there is a cash grant, and thus a direct transfer of funds,⁸⁵

⁷⁷ SCM, *supra* note 12.

⁷⁸ *Id.*

⁷⁹ *Id.* arts. 2 & 3 (article 2 narrows the scope of the SCM by stating that the SCM applies only to specific and not general subsidies. General subsidies are strictly prohibited under the WTO framework. A "Specific" subsidy is one available only to an enterprise, industry, group of enterprises, or group of industries in the country (or state, etc) that gives the subsidy. Additionally, specific subsidies can be domestic or export subsidies).

⁸⁰ *Id.* arts. 4 & 7 (stating the remedies available to WTO countries under the SCM).

⁸¹ See SCM, *supra* note 12, arts. 9, 17 & 19 (noting the availability of procedures for consultations, provisional CVD measures, and collection of countervailing duties).

⁸² *Id.* art.1 (providing the definition of subsidy and giving examples).

⁸³ *Id.* Panel Report, *Korea—Measures Affecting Trade In Commercial Vessels*, ¶¶ 7.120-7.126, 7.25-7.35, WT/DS273/R (Mar. 7, 2005), available at [http://www.worldtradelaw.net/reports/wtopanelsfull/korea-vessels\(panel\)\(full\).pdf](http://www.worldtradelaw.net/reports/wtopanelsfull/korea-vessels(panel)(full).pdf) (the Panel held that the loans and loan guarantees at issue fell under Article 1.1(a)(1)(i) and rejected Korea's argument that this provision covers only "government practices," which do not apply to functions normally performed by banks. The Panel accepted the European Communities argument that the APRG program "provides for a 'potential direct transfer of funds' within the meaning of Article 1.1(a)(1)(i).") [hereinafter *Korea—Commercial Vessels*].

⁸⁴ See *id.*, *supra* note 83, ¶¶ 7.49-7.50.

⁸⁵ Panel Report, *Canada—Measures Affecting the Export of Civilian Aircraft*, ¶ 9.306, WT/DS70/R (Apr. 14, 1999), available at [http://www.worldtradelaw.net/reports/wtopanelsfull/canada-aircraft\(panel\)\(full\).pdf](http://www.worldtradelaw.net/reports/wtopanelsfull/canada-aircraft(panel)(full).pdf) (the dispute Panel noted that the TPC contributions constituted "financial contributions" by a

but not all benefits are so easily discernible.⁸⁶ Article 14 of the SCM Agreement provides some guidance with respect to determining whether certain types of measures confer a benefit, however, it does not provide complete guidance as to the meaning of “benefit.”⁸⁷ In *Canada—Aircraft*, the WTO Appellate Body provided clarification when it found that the existence of a benefit should be determined by comparison with the marketplace (i.e., on the basis of what the recipient could have received in the market).⁸⁸

The SCM Agreement divides specific subsidies into two categories: prohibited and actionable (i.e., subject to challenge in the WTO or to countervailing measures).⁸⁹ According to Article 2 of the SCM, all specific subsidies fall into one of these categories.⁹⁰

Further, Article 3.1 provides two categories of prohibited subsidies: (1) “subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance” (export subsidies), and (2) “subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods” (local content subsidies).⁹¹ These subsidies are strictly prohibited by Article 3.2 of the SCM.⁹² Thus, a WTO member can challenge prohibited subsidies and impose countervailing measures, as provided under Article 4.⁹³

public body within the meaning of Article 1.1 of the SCM Agreement, as they were direct transfers of funds from the government of Canada, as required by Article 1.1(a)(1)(i). [hereinafter *Canada—Aircraft*].

⁸⁶ In *Korea—Commercial Vessels*, the Panel rejected the European Communities’ allegations of subsidization and found that “although certain provisions of the KLR might indicate that its was intended as a means of providing subsidies, a conclusion that the KLR could be applied in a manner that confers a benefit would not be a sufficient basis to conclude that the KLR as such is mandatory legislation susceptible of inconsistency with Article 3.1 of the SCM Agreement.” See *Korea—Commercial Vessels*, *supra* note 83, ¶¶ 7.68-7.107.

⁸⁷ *Id.*

⁸⁸ Appellate Body Report, *Canada—Measures Affecting the Export of Civilian Aircraft*, ¶¶ 149-161, WT/DS70/AB/R (Aug. 2, 1999), available at http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds70_e.htm (follow “Appellate Body Report” hyperlink) (Affirming the Panel’s finding of the definition of a benefit under Article 1.1(b) of the SCM Agreement, the Appellate Body said that “a benefit places the recipient in a more advantageous position that would have been the case but for the financial contribution”); Panel Report, *United States—Imposition of Countervailing Duties on Certain Hot-Rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom*, ¶¶ 6.22-6.86, WT/DS138/R (Dec. 23, 2005), available at <http://www.worldlii.org/int/cases/WTOP/1999/7.html> (moreover, in *U.S.—Lead Bars*, the Panel said that because fair market value was paid for all productive assets, goodwill etc., it could not see how the “financial contributions” given to the original company could confer a “benefit” on the latter companies.) [hereinafter *U.S.—Lead Bars*].

⁸⁹ *Understanding the WTO*, *supra* note 13.

⁹⁰ SCM, *supra* note 12, art. 2 (stating that “a subsidy which is limited to certain enterprises located within a designated geographical region within the jurisdiction of the granting authority shall be specific” and that “any subsidy falling under the provision of Article 3 shall be deemed to be specific”).

⁹¹ *Id.* art. 3.1 (listing the types of prohibited subsidies under the SCM).

⁹² *Id.* art. 3.2 (stating that “a Member shall neither grant nor maintain subsidies referred to in paragraph 1” of Article 3, namely export or local content subsidies).

⁹³ *Id.* art. 4 (specifying the remedies available to a Member challenging a prohibited subsidy granted or maintained by another WTO country).

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Actionable subsidies are a member's subsidies that cause adverse effects to the interests of other WTO members.⁹⁴ Article 5 of the SCM enumerates three types of adverse effects that may be at issue in an SCM challenge.⁹⁵ First, an adverse effect may be an "injury to the domestic industry of another member" caused by subsidized imports in the territory of the complaining country.⁹⁶ Injury in the domestic market of the adversely affected WTO country is the sole basis for applying countervailing measures.⁹⁷ A second type of adverse effect is "serious prejudice to the interests of another member."⁹⁸ Serious prejudice usually arises as a result of adverse effects (i.e., export displacement) in the market of the subsidizing country or in a third country market.⁹⁹ Thus, unlike injury, it can serve as the basis for a complaint related to harm to a member's export interests. In other words, in a serious prejudice claim, the increased imports cause harm not on the domestic market of the complaining country but on its export interests.¹⁰⁰

Article 6 provides additional provisions regarding what constitutes serious prejudice within the context of Article 5(c).¹⁰¹ Article 6.1 lists four types of subsidies where serious prejudice may exist: (1) certain *ad valorem* subsidization, (2) subsidies to cover industry operating losses, (3) subsidies to cover enterprise operating losses, and (4) direct debt forgiveness.¹⁰² Furthermore, for serious prejudice to exist within the context of Article 5(c), an Article 6.1 subsidy must result in one or several of the effects enumerated in Article 6.3.¹⁰³ Article 6.3 provides that serious prejudice results when the subsidy displaces or impedes the imports or exports of another member in the subsidizing country's market or in a third market, or when the subsidy results in loss of sales or market share.¹⁰⁴

⁹⁴ *Id.* art. 5 (noting that no member should cause, through the use of subsidies, adverse effects to the interests of other WTO members and enumerating those adverse effects).

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ *See id.* art. 5, n. 11 & art. 19.

⁹⁸ *Id.* art. 5; *see also* Panel Report, *United States—Subsidies on Upland Cotton*, ¶¶ 7.1494-7.1495, WT/DS267/R (Sept. 8, 2004), available at http://www.wto.org/english/tratop_e/dispu_e/dispu_e267r_a_e.pdf (holding that "threat" of serious prejudice refers to something distinct from "serious prejudice," but that "serious prejudice" is "necessarily including the concept of 'threat' and exceeding the presence of 'threat' for purposes of answering the relevant inquiry") [hereinafter *U.S.—Upland Cotton*].

⁹⁹ *See* SCM, *supra* note 12, art. 6.3 (enumerating the situations where serious prejudice in the sense of Article 5(c) may exist).

¹⁰⁰ *See* SCM; *see also* *U.S.—Upland Cotton*.

¹⁰¹ SCM, *supra* note 12, art. 6 (delineating the situations when serious prejudice will be deemed to exist under the SCM Agreement).

¹⁰² *Id.* art. 6.1.

¹⁰³ *Id.* art. 6.2 (stating that "notwithstanding the provisions of paragraph 1, serious prejudice shall not be found if the subsidizing Member demonstrates that the subsidy in questions has not resulted in any of the effects enumerated in paragraph 3").

¹⁰⁴ *Id.* art. 6.3. Art. 6.3 provides:

Serious prejudice in the sense of paragraph (c) of Article 5 may arise in any case where one or several of the following apply: (a) the effect of the subsidy is to displace or impede the imports of a like product of another Member into the market of the subsidizing Member; (b) the effect of the subsidy is to displace or impede the exports of a like product of another Member from a third country market; (c) the effect of the subsidy is a significant price undercutting by the subsidized product as compared with the price of a like product of another Member in the same market or

A third type of adverse effect listed in Article 5 is nullification or impairment of benefits accruing under GATT 1994.¹⁰⁵ Nullification or impairment arises most typically when subsidization undercuts the improved market access presumed to flow from a bound tariff reduction.¹⁰⁶ Unlike injuries to the domestic market or to export interests, under a nullification or impairment classification, the injury is to the country's anticipated benefits from the better market access.

Article 7 provides the remedies available to a WTO country alleging one or more Article 5 adverse effects.¹⁰⁷ Specifically, Article 7 provides for initial consultations between interested parties.¹⁰⁸ However, if consultations do not produce a mutually satisfying result, the parties may refer the dispute to the WTO Dispute Settlement Body ("DSB").¹⁰⁹ If the DSB makes an affirmative determination that an actionable subsidy exists, the member providing the subsidy must withdraw it or eliminate its adverse effects.¹¹⁰ If the subsidizing member fails to do so, the complaining country may impose countervailing measures.¹¹¹

Therefore, a WTO country may use the SCM Agreement to protect its industry against prohibited and actionable subsidies. Prohibited subsidies must be immediately withdrawn according to Article 4.¹¹² Actionable subsidies carry a more demanding burden of proof since the challenging country must prove the existence of one or more of the adverse effects of Article 5.¹¹³ However, if the challenger meets its burden of proof, it can use the remedial provisions of Article 7 to remove the subsidy's adverse effects or impose countervailing measures.¹¹⁴

2. *Special and Differential Treatment for Transitional Economies and Developing Countries*

Recognizing that subsidies may play an important role for countries in the process of transforming to a market economy, the SCM Agreement provides members undergoing the transition with special and differential treatment under Article 29.¹¹⁵ Article 29.1 provides that "members in the process of transforma-

significant price suppression, price depression or lost sales in the same market; (d) the effect of the subsidy is an increase in the world market share of the subsidizing Member in a particular subsidized primary product or commodity as compared to the average share it had during the previous period of three years and this increase follows a consistent trend over a period when subsidies have been granted.

¹⁰⁵ See SCM, *supra* note 12, art. 5(b) (stating when nullification or impairment will be deemed to occur).

¹⁰⁶ *Id.*

¹⁰⁷ *Id.* art. 7.

¹⁰⁸ See *id.* arts. 7.1-7.3. (stating the remedies available for WTO countries when they successfully show injury to their domestic industry, nullification or impairment, or serious prejudice under the SCM).

¹⁰⁹ See *id.* arts. 7.4-7.7.

¹¹⁰ See *id.* art. 7.8.

¹¹¹ See *id.* arts. 7.9-7.10.

¹¹² See SCM, *supra* note 12, art. 4.

¹¹³ See *id.* arts. 4-7 & 19.

¹¹⁴ See *id.* art. 7.

¹¹⁵ *Id.* art. 29.

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tion from a centrally-planned into a market, free-enterprise economy may apply programmes and measures necessary for such transformation.”¹¹⁶ Under Article 29.2, members have a seven-year period from the date of entry into the WTO to phase out export or local content subsidies that have been deemed prohibited under Article 3 and that have been notified as required under article 29.3.¹¹⁷ During this seven-year period, subsidies falling under Article 6.1, granted in the form of direct debt forgiveness or grants to cover debt repayment, are not actionable.¹¹⁸ In addition, Article 29.4 provides that in exceptional circumstances the member in transition may depart from its notification program, if such departure is necessary for the process of transformation into a market economy.¹¹⁹ For all other actionable subsidies that are not explicitly provided for under Article 29, Article 29.2(b) states that Article 27.9 applies.¹²⁰

Article 27 is part of the SCM provisions regarding developing countries. It confers special and differential treatment to developing WTO countries in recognition of the role that subsidies play in their economic development.¹²¹ Article 29.2(b) expressly refers to the provisions of Article 27.9, which, in turn, provides that

[R]egarding actionable subsidies granted or maintained by a developing country Member other than those referred to in paragraph 1 of Article 6, action may not be authorized or taken under Article 7 unless nullification or impairment of tariff concessions or other obligations under GATT 1994 is found to exist as a result of such subsidy, in such a way as to displace or impede imports of a like product of another Member into the market of the subsidizing developing country Member or unless injury to a domestic industry in the market of an importing Member occurs.¹²²

¹¹⁶ *Id.* art. 29.1.

¹¹⁷ *Id.* art. 29.2, stating that:

[f]or such Members, subsidy programmes falling within the scope of Article 3, and notified according to paragraph 3, shall be phased out or brought into conformity with Article 3 within a period of seven years from the date of entry into force of the WTO Agreement. In such a case, Article 4 shall not apply

See also *id.* art. 29.3, explaining that:

[s]ubsidy programmes falling within the scope of Article 3 shall be notified to the Committee by the earliest practicable date after the date of entry into force of the WTO Agreement. Further notifications of such subsidies may be made up to two years after the date of entry into force of the WTO Agreement.

¹¹⁸ See *id.* arts. 6.1 & 29.2.

¹¹⁹ *Id.* art. 29.4 (noting that “[i]n exceptional circumstances Members referred to in paragraph 1 may be given departures from their notified programmes and measures and their time-frame by the Committee if such departures are deemed necessary for the process of transformation”).

¹²⁰ *Id.* art. 29.2(b) (providing that “[w]ith respect to other actionable subsidies, the provisions of paragraph 9 of Article 27 shall apply”).

¹²¹ SCM, *supra* note 12, art. 27 (stating that the SCM provides for special provision for subsidies granted by developing countries).

¹²² *Id.* arts. 27.9 & 29.2(b).

Additionally, Article 27.13 may be applicable as it refers to the same type of subsidies enumerated in Article 29.¹²³ Specifically, Article 27.13 states that direct forgiveness of debt and subsidies to cover social costs in whatever form will not be actionable subsidies under the SCM when they are linked to the privatization program of the developing country, have limited duration, and are notified.¹²⁴

Thus, the provisions of Article 29 concerning transitioning economies and those of Article 27 regarding developing countries protect the subsidies of the WTO members that meet certain criteria.¹²⁵ Accordingly, China's alleged textile subsidies may be protected under the provision of Articles 27 and 29, as China is, arguably, both a non-market economy in transition and a developing country.¹²⁶

B. Applying the SCM Provisions to Chinese Textile Subsidies

1. Subsidy

China currently has subsidies that could be actionable under the SCM Agreement but for Article 29. China provides subsidies in the forms of grants and tax forgiveness, assistance by local budget, preferential tariff rates, tax and tariff refunds.¹²⁷ These subsidies are actionable subsidies under Article 6 of the SCM.¹²⁸ In addition, China provides loans contingent on export performance, which are prohibited subsidies under SCM Article 3.¹²⁹ China, however, is currently in transition toward becoming a market economy, and Article 29 of the SCM protects any reported subsidy programs that would facilitate its transition.¹³⁰

As discussed above, Article 29 explicitly protects transitioning economies from WTO actions in relation to (a) notified prohibited subsidies under Article 3 and (b) notified actionable subsidies under article 6.1(d).¹³¹ Article 29 evinces a WTO policy concern for the transformation of non-market economies into free

¹²³ *Id.* arts. 27.13 & 29.

¹²⁴ *See* SCM, *supra* note 12, art. 27.13. Article 27.13 states:

The provisions of Part III shall not apply to direct forgiveness of debts, subsidies to cover social costs, in whatever form, including relinquishment of government revenue and other transfer of liabilities when such subsidies are granted within and directly linked to a privatization programme of a developing country Member, provided that both such programme and the subsidies involved are granted for a limited period and notified to the Committee and that the programme results in eventual privatization of the enterprise concerned.

¹²⁵ *See supra* Part II.A.2.

¹²⁶ *See id.*

¹²⁷ *See* Accession Agreement, *supra* note 6, at Annex 5A, 5B (reporting the subsidies currently in place in China, which will eventually be eliminated).

¹²⁸ *See* SCM, *supra* note 12, art. 6.

¹²⁹ *Id.* art. 3.1.

¹³⁰ *See id.* art. 29; *see also* Accession Agreement, *supra* note 6, at Annex 5A, 5B (in its WTO Accession Agreement, the Chinese government notified the textiles subsidy programs it currently has in place but will phase-out as China transforms itself into a market economy).

¹³¹ *See supra* Part II.A.2.

market ones;¹³² it is clearly intended to allow transition-economy members extra flexibility in using subsidies to achieve their economic reform.¹³³ China is a WTO member in the process of transformation to a market economy and its textile subsidies may fall squarely within the provisions of Article 29.¹³⁴ Consequently, Article 29 may preclude a WTO member from invoking the SCM against subsidized Chinese textiles.¹³⁵

However, Article 29 does not constitute an absolute ban on actions against subsidization maintained by a transitioning economy. It grants protection to specific types of subsidies, which must be reported, or when “critical circumstances” necessitate subsidization to help the transition into a market economy.¹³⁶ Arguably, Article 29 does not preclude a WTO country from seeking remedies for those subsidies that do not meet the requirements of Article 29. Such “unprotected” subsidies will be (a) present absent any “critical circumstances” and without their notification, and (b) of a type other than those explicitly provided for under Article 29, including preferential access to loans.¹³⁷

According to Article 1 of the SCM, preferential access to loans would be a subsidy because it is an indirect financial contribution by a public body.¹³⁸ It is more likely than not that the Chinese government will be involved one way or another in the preferential treatment of its textile producers, since China is not yet

¹³² The trend toward globalization and liberalization of the world economy exerts great pressure on developing countries. See *The WTO in Brief: Trade and Development*, WTO Online, http://www.wto.org/english/thewto_e/whatis_e/inbrief_e/inbr04_e.htm (last visited Mar. 10, 2006). The WTO regime recognizes the difficulties developing non-market countries may encounter in their transformation into market economies and provides a range of measures in support of their adjustment process.

All WTO agreements contain special provision for [developing countries], including longer time periods to implement agreements and commitments, measures to increase their trading opportunities, provisions requiring all WTO members to safeguard their trade interests, and support to help them build the infrastructure for WTO work, handle disputes, and implement technical standards.

Id.

¹³³ Julia Ya Qin, *WTO Regulation of Subsidies to State-Owned Enterprises (SOES)—A Critical Appraisal of the China Accession Protocol*, 7 J. INT’L ECON. L. 863, 868 (2004).

¹³⁴ If the transition economy is also a developing country, such programs and measures may also be exempted under Article 27.13 of the SCM as subsidies to assist privatization. See SCM, *supra* note 12, art. 27.13. The exception provided by Article 29 is broader in scope than Article 27.13, but is limited to the seven-year period. See *id.* Consequently, the provisions of Article 27 also apply to China’s subsidies, because China is a developing country. See *id.* art. 27. However, Article 27.13 will not apply to Chinese subsidies in the form of preferential access to loans, because this type of subsidy is not provided for in the language of Article 27.13. See *id.* art. 27.13. Article 27.13 would still not apply even if the Chinese textile subsidies at issue were provided for in its text, because China’s Accession Agreement does not include such form of textile subsidies in its notification reports as required under this article. See *id.* Lastly, unlike Article 29.4, Article 27.13 does not allow departures from the Member-notified programs. See SCM, *supra* note 12, art 27.13.

¹³⁵ See *id.* art. 29.

¹³⁶ See *supra* Part III.A.2.

¹³⁷ *Id.*; see also 2004 REPORT, *supra* note 7, at 263-64.

¹³⁸ See SCM, *supra* note 12, art. 1; see also Panel Report, *Canada—Export Credits and Loan Guarantees for Regional Aircraft*, ¶¶ 7.66, 7.141-7.142, WT/DS222/R (Jan. 28, 2002) available at [http://www.worldtradelaw.net/reports/wtopanelsfull/canada-aircraftII\(panel\)\(full\).pdf](http://www.worldtradelaw.net/reports/wtopanelsfull/canada-aircraftII(panel)(full).pdf) (finding that if the various measures at issue involve “direct” or “potential direct” transfers of funds, they are financial contributions within the meaning of Article 1.1 of the SCM) [hereinafter *Canada—Aircraft II*].

a market economy.¹³⁹ In addition, the government has a stake in the control of most of the Chinese financial institutions.¹⁴⁰ The Chinese banks involved are not completely independent and therefore constitute public bodies for SCM purposes.¹⁴¹

Moreover, preferential access to loans is an indirect financial contribution according to the SCM provisions. A loan is by definition a transfer of funds, in this case, to the textile and apparel factories.¹⁴² Preference in granting a loan is an indirect transfer of funds and, thus, an indirect financial contribution that confers a financial advantage, or benefit, to the Chinese textile industry in relation to its market position prior to the financial contribution.¹⁴³ According to the holding of *Canada-Aircraft*, the financial contribution conferred to the Chinese apparel and textile factories places them in a more advantageous position in the world market than would have been the case but for the financial contribution.¹⁴⁴ Chinese textile and apparel industries benefit from having preferential access to credit.¹⁴⁵ Such benefit meets the third element of the SCM subsidy definition and, consequently, completes the requirements for a subsidy under Article 1 of the SCM.¹⁴⁶

A subsidy in the form of preferential access to loans is not a prohibited subsidy under Article 3 and, thus, it does not fall under the protective provisions of Article 29.2.¹⁴⁷ According to Article 3 of the SCM, the subsidy is strictly prohibited if it is solely, or as one of several conditions, contingent on export performance.¹⁴⁸ Likewise, if the subsidy is contingent upon the use of domestic over imported goods, either solely or as one of several other conditions, it is strictly prohibited.¹⁴⁹ As shown earlier, Article 29.2 prevents WTO action against reported Article 3 subsidies.¹⁵⁰ Since preferential access to loans does not have any conditions attached to it, this is not an export subsidy or a local content subsidy.¹⁵¹ Consequently, preferential access to loans will not be a prohibited

¹³⁹ See *id.* See generally Accession Agreement, *supra* note 6, sec. 15. Unlike the United States, some countries recognize China as a market economy. China's Accession Agreement provides for such market economy treatment in Section 15.

¹⁴⁰ See Pesek, *supra* note 3.

¹⁴¹ See *id.*

¹⁴² See OXFORD DICTIONARY AND THESAURUS (Amer. ed. 1997).

¹⁴³ See SCM, *supra* note 12, art. 1; see also *Canada—Aircraft II*, *supra* note 138, ¶¶ 7.66, 7.141-7.142,

¹⁴⁴ See *Canada Aircraft*, *supra* note 88, ¶¶ 9.306-9.307.

¹⁴⁵ See SCM, *supra* note 12, art. 1; see also *Canada—Aircraft II*, *supra* note 138, ¶¶ 7.66 & 7.141-7.142,

¹⁴⁶ See SCM, *supra* note 12, art. 1.

¹⁴⁷ See SCM, *supra* note 12, arts. 3 & 29.2.

¹⁴⁸ See *id.* art. 3.1.

¹⁴⁹ See *id.* art. 3.2.

¹⁵⁰ See SCM, *supra* note 117.

¹⁵¹ See SCM, *supra* note 12, art. 3, n.4 (stating that an export subsidy must be "in fact tied to actual or anticipated exportation or export earnings").

subsidy under Article 3 of the SCM, and thus it does not fall under the protective provisions of Article 29.2.¹⁵²

Moreover, Article 29.3 does not apply because preferential access to loans is not an Article 3 subsidy.¹⁵³ Article 29.3 provides for the reporting of Article 3 subsidies.¹⁵⁴ Therefore, the preamble and paragraph (a) of Article 29.2 and Article 29.3 would not prevent action against China's preferential access to loans for its textile industry.¹⁵⁵

Also, preferential access to loans is not a subsidy within the scope of Article 6.1(d) of the SCM and is not a subsidy protected under Article 29.2(a).¹⁵⁶ Article 6.1 explicitly provides for "direct forgiveness of debt, i.e. forgiveness of government-held debt, and grants to cover debt repayment."¹⁵⁷ As shown earlier, Article 29.2(a) prohibits WTO action against subsidies expressly provided for under Article 6.1(d).¹⁵⁸ Preferential access to loans is neither debt forgiveness nor a grant to cover debt repayment, and thus it is not a subsidy within the meaning of Article 6.1(d). Consequently, preferential access to loans is not explicitly prohibited under Article 6.1(d), nor is it a subsidy protected under Article 29.2(a).¹⁵⁹

Alternatively, even if preferential access to loans were either a prohibited subsidy under Article 3 or a subsidy within the scope of Article 6.1(d), it would not be protected by Article 29.2 because it has not been reported.¹⁶⁰ China's Accession Agreement includes a commitment to eliminate trade barriers and provide subsidy notification reports.¹⁶¹ While China's subsidy notifications report preferential loan treatment for the Chinese automobile industry, they do not report any preferential loan treatment for the textile industry.¹⁶² The provisions of Article 29.2 require the notification of subsidy programmes falling within the scope of either Article 3 or Article 6.1(d) and provide for their prospective elimination.¹⁶³ Accordingly, preferential access to loans would not fall within the protective provisions of Article 29.2 because China has not met the notification requirement. Therefore, the preamble and paragraph (a) of Article 29.2 do not apply to Chinese textile subsidies in the form of preferential access to credit because these subsidies do not fall under the provisions of either Article 3 or Article 6.1(d).¹⁶⁴

¹⁵² *Id.*

¹⁵³ Because it is not a subsidy under Article 3, it does not fall under 29.3, which provides for article 3 subsidies. *Id.* art. 29.3.

¹⁵⁴ *Id.*

¹⁵⁵ *Id.* arts. 29.2 & 29.3.

¹⁵⁶ *See id.*

¹⁵⁷ *Id.*

¹⁵⁸ *See id.*

¹⁵⁹ *See SCM, supra* note 12, arts. 6.1 & 29.2.

¹⁶⁰ *See supra* note 117.

¹⁶¹ Accession Agreement, *supra* note 6, at Annex 5A, 5B.

¹⁶² *Id.*

¹⁶³ SCM, *supra* note 12, art. 29.2.

¹⁶⁴ *Id.*

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However, in a potential challenge, China may argue that preferential access to credit for its textile producers is necessary for the economy's transformation under Article 29.1 or Article 29.4. Article 29.1 allows WTO members to apply subsidy programs necessary for the transition to a free market economy.¹⁶⁵ Thus, China must show that the subsidization of its textile industry through preferential access to loans is necessary for its transition to a market economy. This is a high burden to meet, given that China has already committed to eliminate all subsidies and reported in its Accession Agreement those subsidies necessary for the transition to a market economy that will be gradually phased out.¹⁶⁶

Similarly, by invoking Article 29.4, China may argue that critical market conditions dictate the subsidization of its textile industry in the form of preferential access to loans.¹⁶⁷ Article 29.4 provides that in exceptional circumstances, a WTO member in transition may depart from its notification program, if such departure is necessary for the process of transforming into a market economy.¹⁶⁸ In order to succeed under this defense, China will have to show the presence of exceptional circumstances in order to justify departure from its notified subsidy programs. Also, it will have to show that preferential access to loans for Chinese textile manufacturers is necessary under these circumstances.¹⁶⁹ Consequently, China has a high burden of proof regarding a potential defense pursuant to Article 29.4.

Arguably, China will most likely be unsuccessful in invoking either Article 29.1 or Article 29.4 as a defense. It took fifteen years of extensive negotiations for China to join the WTO.¹⁷⁰ It seems unlikely that the drafters of China's Accession Agreement would omit or fail to report preferential access to loans for the textile industry when they provide a detailed description of the subsidies provided to the Chinese textile industry and of the sectors of the Chinese economy that otherwise enjoy preferential access to credit.¹⁷¹ Also, it does not seem likely that China's progress toward a market economy necessitates any more trade distorting measures than those already in place.¹⁷² Consequently, preferential access to loans for the Chinese textile industry does not fall under Articles 29.1 and 29.4 of the SCM.

¹⁶⁵ *Id.* art. 29.1.

¹⁶⁶ See Accession Agreement, *supra* note 6, at Annex 5A, 5B.

¹⁶⁷ See SCM, *supra* note 12, art. 29.4.

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

¹⁷⁰ See Rumbaugh & Blancher, *supra* note 59, at 3.

¹⁷¹ Accession Agreement, *supra* note 6, at Annex 5A, 5B. One may argue that China may deny that it provides preferential access to loans for its textile industry, however such claim will be hard to prove given the existing reports on such subsidization. See 2004 REPORT, *supra* note 7, at 263. Also, China will not succeed in showing that preferential access to loans is not a subsidy, since preferential access to loans falls squarely within the subsidy definition of the SCM. See SCM, *supra* note 12.

¹⁷² See generally Accession Agreement, *supra* note 6, at Annex 5A, 5B; Wen, *supra* note 60; Rumbaugh & Blancher, *supra* note 59.

2. *Application of Article 29*

Nevertheless, Article 29 will still be applicable because of Article 29.2(b) which provides: “[w]ith respect to other actionable subsidies, the provisions of paragraph 9 of Article 27 shall apply.”¹⁷³ Article 27.9 requires either that “nullification or impairment of tariff concessions or other obligations under GATT 1994 is found to exist as a result of such a subsidy”¹⁷⁴ or that the subsidized imports are causing injury in the industry of the importing country.¹⁷⁵ The nullification requirement of Article 27.9 is similar to that of Article 5(b) and demands a WTO country showing that the subsidy nullifies or impairs its benefits under GATT.¹⁷⁶

Under GATT, Article XXIII addresses nullification or impairment.¹⁷⁷ Article XXIII allows a WTO country to bring a claim that “any benefit accruing to it directly or indirectly under this Agreement is being nullified or impaired” as a result of China’s preferential loan access of its textile industry.¹⁷⁸ The complaining WTO member “bears the burden of providing a detailed justification for its claim in order to establish a presumption that what is claimed is true.”¹⁷⁹ According to the WTO Panel in *Japan—Film*, the complaining party must show that “the claimed benefit has been that of legitimate expectations of improved market-access opportunities.”¹⁸⁰ Furthermore, the Panel held that a reasonable anticipation must be assessed on a case-by-case basis.¹⁸¹

A country challenging China’s subsidy may argue that it reasonably anticipated the elimination of the subsidies provided to the Chinese textile industry. For its WTO accession, China committed to the elimination of all subsidies and reported those subsidies that will be phased out during its transition to a market

¹⁷³ SCM, *supra* note 12, art. 29.2.

¹⁷⁴ See SCM, *supra* note 12, art. 27.9. Article 27 applies to developing countries. The WTO does not provide a definition of developed countries. Members announce for themselves whether they are developed or developing countries and other members can challenge such an announcement. See World Trade Organization, Who are the Developing Countries in the WTO?, http://www.wto.org/english/tratop_e/devel_e/d1who_e.htm (last visited Mar. 11, 2006). Arguably, China is a developing country and Article 27 of the SCM might apply as a whole to its subsidies. For our purposes, only Articles 27.9 and 27.13 are relevant. Article 27.13 applies for notified subsidies in the form of direct debt forgiveness and subsidies to cover social costs. See SCM, *supra* note 12, art. 27.13. Thus, Article 27.13 does not apply to subsidies in the form of preferential access to loans.

¹⁷⁵ SCM, *supra* note 12, art. 27.9.

¹⁷⁶ See *id.* arts. 5, 27.9.

¹⁷⁷ GENERAL AGREEMENT ON TARIFFS AND TRADE, Oct. 30, 1947, 61 Stat. A-11, 55 U.N.T.S. 194, art. XXIII, http://www.wto.org/english/docs_e/legal_e/gatt47_e.pdf (last visited Mar. 8, 2006) [hereinafter GATT].

¹⁷⁸ See GATT, *supra* note 177.

¹⁷⁹ Panel Report, *Japan—Measures Affecting Consumer Photographic Film and Paper*, ¶ 10.32, WT/DS44/R (Mar. 31, 1998), available at http://www.wto.org/English/tratop_e/dispu_e/44r00.pdf [hereinafter *Japan—Film*]. The United States brought a challenge against the Japanese distribution scheme of consumer photographic film and paper, which excluded exports from other traditional distribution channels.

¹⁸⁰ *Id.* ¶ 10.61.

¹⁸¹ *Id.* ¶ 10.79.

economy.¹⁸² Another WTO country could reasonably expect the textile market to be more accessible after the expiration of all textile quotas, given China's commitment toward free trade as expressed in the Accession Agreement.

3. *Injury and Causation*

A WTO member challenging Chinese textile subsidies in the form of preferential access to loans may have difficulty meeting the causation requirement of Article XXIII. The challenging country must show that the nullification or impairment of its benefits arises directly from this specific type of subsidy. However, China enjoys a comparative advantage in the production of textiles and has a defense based on the comparative advantage theory.¹⁸³ In other words, China has the ability to produce and export textiles quickly and at a low cost, which arguably gives it an advantage in textile production. In addition, China may defend itself by arguing that there are other economic factors that negatively affect the domestic industry of the complaining country.

In order to meet its burden of proof under Article XXIII, the complaining country must show that the alleged nullification or impairment directly results from China's preferential credit treatment of its textile industry. Accordingly, a complainant must show that the subsidy caused the injury and upset the competitive position of its textiles.¹⁸⁴ This is a substantial hurdle for a complainant to overcome because of China's comparative advantage in textiles.

Neither the dominance of Chinese textiles in the world market nor the lack of competitiveness of textiles from other countries is due to the preferential credit access of Chinese textile manufacturers. Rather, they are the result of China's comparative advantage in textiles.¹⁸⁵ China has the raw materials, the labor force, the machinery and the shipping ability to produce at low costs, to sell at low prices and to quickly export large quantities of textiles.¹⁸⁶ Furthermore, the expiration of the ATC removed all restraints that could have prevented the Chinese textile and apparel industry from exploiting its comparative advantage in textiles and, eventually, conquering the world textile market. However, if China responds to an SCM challenge with a defense based on its comparative advantage in textiles, such a defense will transform the dispute into a debate about the benefits and drawbacks of the free-trade system itself. For this reason, the holding in *Japan—Film*, that the remedy of Article XXIII is a very important tool which

¹⁸² See generally Accession Agreement, *supra* note 6.

¹⁸³ See *infra* Part IV.A and accompanying notes.

¹⁸⁴ See *Japan—Film*, *supra* note 179, ¶¶ 10.82-10.89 & 10.318. The Panel required a causal link between subsidies provided and nullification or impairment. *Id.* ¶¶ 10.82, 10.349. The United States must show that the upset in the competitive relationship between domestic and imported products are the direct result of the measure, not because of any effect on trade flows. *Id.* But the United States did not meet its burden of proof. *Id.*

¹⁸⁵ See *infra* Part IV.A.

¹⁸⁶ See *infra* Part IV.B. and accompanying notes.

should “be approached with caution and should remain as an exceptional remedy,”¹⁸⁷ becomes relevant to an SCM action against Chinese textiles.

In addition, the second prong of Article 27.9 requires a showing of injury to the domestic industry, thus, there must be a causal link between subsidized imports and the alleged injury.¹⁸⁸ Article 15.5 explains: “It must be demonstrated that the subsidized imports are, through the effects of subsidies, causing injury within the meaning of this Agreement.”¹⁸⁹ The impact of subsidized textile imports upon the domestic textile industry of the complaining country will be examined in light of “all relevant economic factors and indices having a bearing on the state of the industry.”¹⁹⁰ Other factors that can have an adverse effect on the domestic textile industry of a member country must also be considered.¹⁹¹ Article 15.5 states that the injury caused to the domestic industry from factors other than the subsidized textiles should not be taken into account in assessing the injury caused by the textile subsidy.¹⁹²

The causation requirement of Article 15 of the SCM may provide China with grounds to defend itself against a possible challenge. Article 15 specifies that a challenging country must show that it is the subsidization of Chinese textiles that gives Chinese textile goods an advantage over domestic products, and that without subsidization, textiles from China would not injure the domestic market.¹⁹³ China, however, may argue in response that the challenging country’s textile sector is shrinking and has been generally unhealthy for the past few years. For example, in a potential challenge from the United States, China may show that the domestic industry is shrinking due to factors other than increased imports of Chinese textiles.¹⁹⁴ Available data shows that the U.S. textile industry is in poor health due to loss of employment, plant closings and over-dependency upon foreign sources for critical textile-related materials or textile imports from other countries.¹⁹⁵ Based upon Article 15 of the SCM, a showing from China that there are other economic factors affecting the state of the U.S. textile industry

¹⁸⁷ *Japan—Film*, *supra* note 179, ¶ 10.30.

¹⁸⁸ SCM, *supra* note 12, arts. 15.5 & 27.9.

¹⁸⁹ See SCM, *supra* note 12, art. 15.5; see also Panel Report, *United States—Investigation of the International Trade Commission in Softwood Lumber from Canada*, WT/DS277/R (Mar. 22, 2004) available at <http://www.worldlii.org/int/cases/WTOP/2004/1.html> (last visited Mar. 9, 2006) (finding that a threat determination should be made against the background of an evaluation of the condition of the industry in light of the factors in Articles 3.4 and 15.4).

¹⁹⁰ SCM, *supra* note 12, art. 15.4 (noting that “[t]he examination of the impact of the subsidized imports on the domestic industry shall include an evaluation of all relevant economic factors and indices having a bearing on the state of the industry”).

¹⁹¹ *Id.* (noting that the list provided in Article 15.4 is not exhaustive).

¹⁹² See SCM, *supra* note 12, art. 15.5 (stating the standard for an injury determination under the SCM).

¹⁹³ See *id.*

¹⁹⁴ See *id.*

¹⁹⁵ See THE U.S. TEXTILE AND APPAREL INDUSTRIES: INDUSTRIAL BASE ASSESSMENT, REPORT TO CONGRESS, EXECUTIVE SUMMARY, Oct. 2003, <http://www.bxa.doc.gov/DefenseIndustrialBasePrograms/OSIES/DefMarketResearchRpts/TextileExecSum03.htm> (last visited Mar. 9, 2006) (stating that the U.S. textile industry has declined over the past few years due to loss of employment, plant closing and dependence of foreign materials) (last visited Apr. 28, 2005); US Home Textile Imports in January-July 2005:

would disprove U.S. claims that the Chinese textile subsidies caused injury to the U.S. textiles sector.¹⁹⁶ Consequently, based on the data available, China may successfully defend its textiles against an alleged injury to the U.S. textile industry.

Moreover, under Article 15 of the SCM, China may invoke its comparative advantage in textiles as a defense. Because of its ability to produce and export textiles quickly and at a low cost, China has a comparative advantage in textiles that, after the elimination of all textile quotas, operates without restrictions.¹⁹⁷ Based on the theory of comparative advantage, countries will produce what they are best at producing. It flows, then, that since China is currently best at producing textiles, it will export the largest number of textiles and the U.S. textile industry will shrink.¹⁹⁸ Thus, the injury alleged is not the result of subsidies but the result of comparative advantage. Because the comparative advantage theory is the basic principle underlying the WTO system,¹⁹⁹ a potential Chinese defense based on the comparative advantage principle will constitute a significant challenge for the opposite party and for the free-trade system itself.

4. Remedies and their Implications

Nevertheless, if a complaining country overcomes the hurdles of Article 29 and successfully shows nullification or impairment, it may then utilize the remedies provided under Article 7 of the SCM Agreement.²⁰⁰ A country alleging that the Chinese textile subsidies injure its domestic industry may request consultations with China.²⁰¹ However, if consultations do not bring about a mutually desired solution, the parties can refer their dispute to the DSB for resolution.²⁰² If the WTO dispute settlement process determines that the subsidy resulted in an adverse effect, China would then have six months to withdraw the subsidy or remove its adverse effects.²⁰³ Otherwise, in the absence of a compensation agreement, the complaining country can impose countervailing measures to Chinese textiles and apparel.²⁰⁴

China vs. India and Pakistan, *available at* <http://www.emergingtextiles.com/?q=com&s=logins&rqART=050929Amark&r=usimports> (last visited Oct. 4, 2005).

¹⁹⁶ See SCM, *supra* note 12, art. 15.4.

¹⁹⁷ See *infra* Part IV.A.

¹⁹⁸ See Barboza & Becker *supra* note 1; Business Report, Chinese Exports Threaten to Destroy Textile and Manufacturing Industries Worldwide (Jan. 19, 2005), *available at* <http://www.tralac.org/scripts/content.php?id=3321> (last visited Apr. 26, 2005); Fong Mei Fong, *Backlash is Likely as Chinese Exports of Apparel Surge*, WALL ST. J., Mar. 28, 2005, at A3.

¹⁹⁹ See Understanding the WTO, *supra* note 13 and accompanying text.

²⁰⁰ SCM, *supra* note 12, arts. 29 & 7 (stating the remedies available to a WTO member that successfully shows a violation of the SCM Agreement by another member).

²⁰¹ *Id.*

²⁰² *Id.*

²⁰³ *Id.*

²⁰⁴ *Id.*

Invoking the SCM Agreement

In addition, the SCM Agreement allows for the imposition of provisional measures.²⁰⁵ According to Article 17, a WTO member can impose provisional countervailing duties against Chinese textiles when there has been a preliminary affirmative determination that a subsidy exists and causes injury to its domestic textile industry.²⁰⁶ Such provisional measures cannot exceed four months.²⁰⁷

However, the complainant must keep in mind that an action can only be brought in relation to “like products.”²⁰⁸ The Panel in *Indonesia—Autos* addressed the issue of “likeness” in examining whether government subsidies to Indonesian automobile manufacturers displaced imports of like passenger cars from the Indonesian market within the meaning of Article 6.3.²⁰⁹ The Panel referred to interpretations of “like products” in other provisions of the WTO Agreement and held that likeness should be assessed in terms of the products’ physical and non-physical characteristics.²¹⁰ The likeness requirement may be significant considering China’s position as a primary producer of the world’s textiles.²¹¹ Countries with smaller textile industries may not be able to show injury if they do not produce like products themselves. Furthermore, because WTO members cannot bring actions on behalf of other WTO countries,²¹² the number of countries that could invoke the SCM provisions is limited by a country’s own capacity in the production of textiles.

Nonetheless, one could argue that once a single country brings a successful SCM complaint against Chinese textile subsidies, there would be a spill over effect to the rest of the countries affected by Chinese textile exports. A WTO ruling that China is in violation of its obligations under the SCM Agreement would potentially force China to lift the subsidies, consequently producing a multilateral benefit as all of China’s trading partners would benefit by their elimination. But, if China does not eliminate the subsidies, it would be subject to unilateral retaliatory measures, which may only benefit the challenging country’s industry. Given China’s current transition to a market economy,²¹³ a lifting of the textiles subsidies at this stage might be premature, hard to implement or otherwise unlikely. Therefore, if a successful SCM challenge is brought in the WTO against China’s textiles, it is likely that the only remedy available to the challenger will be retaliation.

²⁰⁵ *Id.* art. 17 (stating that provisional CVD measures are available to WTO members and providing the procedures for their implementation).

²⁰⁶ *Id.*

²⁰⁷ *Id.*

²⁰⁸ *Indonesia—Certain Measures Affecting the Automobile Industry*, Report of the Panel, WT/DS54,55,59,64/R, ¶ 14.163-14.204 (July 2, 1998).

²⁰⁹ *Id.*

²¹⁰ *Id.*

²¹¹ Trade Policy Monitor: The Downside of PRC WTO Accession: Textiles & Clothing, available at http://www.thunderlake.com/prc_tandc.html (last visited Apr. 25, 2005) (stating that China is the world’s largest exporter of textiles and apparel products).

²¹² See SCM, *supra* note 12 and accompanying text.

²¹³ See TAO & O’BRIEN, *supra* note 59.

Despite the significant limitations on their invocation,²¹⁴ countervailing duties imposed under the SCM provisions have advantages in comparison to the measures available under the China Accession Agreement.²¹⁵ Under the SCM, a WTO member does not need to reapply every year in order to impose countervailing measures to subsidized Chinese textiles.²¹⁶ In addition, it can apply provisional measures while pending elimination of the subsidy or determination by the DSB.²¹⁷ It is more likely that China will be more responsive to countervailing duties imposed under the SCM than to measures imposed under its Accession Agreement, because of economic costs and legitimacy reasons. An official WTO recognition that the flood of subsidized Chinese textiles poses a problem to the world markets, coupled with a negative finding by the DSB, would exert pressure on China to reconsider its foreign trade policy and legitimize its means.²¹⁸ An elimination of the Chinese textiles subsidies would benefit all its trading partners. Consequently, if a country successfully overcomes the hurdles of invoking the SCM Agreement, the SCM may provide a more compelling and multilateral solution to the problem of Chinese textiles than the unilateral remedies provided in China's WTO Accession Agreement.

IV. China's Textiles, their Comparative Advantage, and the Evolution of International Trade

The termination of all textile quotas constitutes a significant challenge for the WTO because of the Chinese comparative advantage in textiles. WTO members fear that the Chinese textile industry is going to grow at their expense and are examining ways to slow down the Chinese expansion in the global textile market.²¹⁹ Part III demonstrated that despite some hurdles, it is possible that WTO members could invoke the provisions of the SCM to impose countervailing duties to textiles from China. However, a possible invocation of the SCM at this stage may be premature and harmful to the free-trade system itself. The expiration of the quota system in textiles requires a period of adjustment within the textile industry. While WTO members have legitimate concerns about the health of their domestic textile industries, they should not overlook the existence of an evolution in international trade. It is exactly this evolutionary process that they consented to when they joined the WTO. Efforts to stop the market adjustments

²¹⁴ See *supra*, Part III.B.

²¹⁵ Similar to the SCM, the Accession Agreement may be applied to like products and after an evaluation of all objective relevant factors regarding the effect of the imports at issue on the domestic industry producing like products. Accession Agreement, *supra* note 6, art. 16.4.

²¹⁶ SCM, *supra* note 12, art. 21 (stating the SCM provisions regarding the duration and review of the imposed CVD measures).

²¹⁷ *Id.* art. 17. However, the Accession Agreement provides for stronger provisional measures than the SCM. Article 15 specifically states that provisional measures can last up to 200 days, which far exceeds that four month limit on SCM provisional measures. See Accession Agreement, *supra* note 6, art. 16.

²¹⁸ Claire Kelly, *The Value Vacuum: Self-Enforcing Regimes and the Dilution of the Normative Feedback Loop*, 22 MICH. J. INT'L L. 705, 705-07 (2001) (explaining that the WTO, viewed either as a self-enforcing or legalized regime, can impose costs to its members for non-compliance either in terms of economic sanctions or of legitimacy).

²¹⁹ *Id.*

following the ATC expiration may nullify the role of comparative advantage in the WTO framework and, consequently, undermine the free-trade system itself.

A. China's Comparative Advantage in Textiles

China is an enormous and fast-growing economy with a comparative advantage in the production of apparel and textiles. China's comparative advantage in the production of textiles and apparel can be traced to several factors: low wage rates,²²⁰ large labor supply,²²¹ more productive workforce,²²² benefits from economies of scale,²²³ industrial base,²²⁴ geographic location,²²⁵ and heavy investment in infrastructure.²²⁶ Undoubtedly, its comparative advantage in textiles makes China one of the biggest textile industries and one of the leading world exporters.²²⁷ China has the raw materials, the workers, the machinery, and the shipping ability to produce at low cost, to sell at low prices and to distribute quickly large quantities of textiles to other markets.²²⁸ In addition, many global clothing companies transfer their manufacturing facilities to China because of the availability of low-cost labor and production materials.²²⁹

Even though China's status in the global textiles market is to a degree attributable to the subsidization of its textile industry, its comparative advantage is not. Arguably, because of China's vast resources, its comparative advantage in textiles would exist even if no subsidization were in place.²³⁰ Alternatively, even if subsidization helps the Chinese textile industry, one cannot attribute China's comparative advantage exclusively to the textile subsidies. To say that subsidies have caused China's comparative advantage in textiles would ignore the presence of other important economic factors (like cheap labor, large labor supply, labor

²²⁰ THE AMERICAN TEXTILE MANUFACTURERS INSTITUTE, *THE CHINA THREAT TO THE WORLD TEXTILE AND APPAREL TRADE* 12 (2005); Linda Lim, *China Shows the Way in a Quota-Free Market* (Feb. 23, 2005), available at <http://www.efu.com.cn/eng/onlinesales/promotion/allround/2005-2-23/7886.htm> (last visited Apr. 25, 2005); Jonathan Steiman, *Expiration of Textile Quota Act Takes Toll on U.S. Manufacturers* (Jan. 13, 2005), available at <http://pf.inc.com/criticalnews/articles/200501/textiles.html> (last visited Apr. 24, 2005) (noting that American textile makers cannot compete with the wages in China, "where the wages run as low as 41 cents per hour").

²²¹ *Id.*

²²² *Id.*

²²³ Chinese factories benefit from economies of scale, given the large production base and domestic market afforded by the country's huge population. See Lim, *supra* note 220 and accompanying text.

²²⁴ China's large, diverse, and increasingly integrated industrial base means that many materials required to make clothing are locally available, avoiding the added costs, risks, and longer delivery lead-times that imported inputs impose on other countries. *Id.*

²²⁵ China's geographic location, close to Japan, Korea, Taiwan, and Hong Kong, allows it to readily import advanced equipment and high-tech textiles for its finishing industries. *Id.*

²²⁶ China has also invested heavily in its physical infrastructure, allowing speed of delivery of both imports and exports. *Id.*

²²⁷ See Business Report, *supra* note 198.

²²⁸ *Id.*; David J. Lynch, *As Quotas End, China Stands Ready to Be Clothing Giant* (Dec. 22, 2004), available at http://www.usatoday.com/money/world/2004-12-21-china-textiles_x.htm.

²²⁹ Rebecca Buckman, *Navigating China's Textile Trade*, WALL ST. J., Sept 10, 2004, at A10.

²³⁰ *Id.*

productivity, etc.), and thus would be an incomplete assessment of China's comparative advantage in textiles.²³¹

Because of its comparative advantage in the production of textiles and apparel, China has the ability to take over the world textile market.²³² According to the comparative advantage theory, it is a "natural consequence" of free trade that China will hold a dominant position in the textiles trade and that textiles from China will take over the world market.²³³ The surge in exports from China and the flood of Chinese textiles in the world market after the expiration of the ATC²³⁴ are the effects of China's comparative advantage in textiles.

B. China's Dominance in Textiles as Part of the Evolution of International Trade

Confronted with China's supremacy in textiles and apparel, WTO members have legitimate concerns with regard to the future of their own domestic industries. Both developed and developing countries fear that their domestic textile industries will either shrink or disappear.²³⁵ Most countries are currently experiencing loss of domestic jobs and loss of domestic and foreign market-share.²³⁶ Countries, like the United States, experience great pressure from their textile industry representatives to impose safeguard measures to stop the Chinese textile import surge.²³⁷

Concerns about China's trade practices further accentuate the fears of WTO countries about the decline of their domestic textile industries. Until recently, China heavily subsidized its textile industry.²³⁸ Commentators argue that it still does.²³⁹ Concerns about subsidization do not seem unreasonable given that China is not a full market economy yet,²⁴⁰ not all of its industries are completely independent of government control,²⁴¹ its currency and banking practices are questionable,²⁴² and transparency in transactions is open to discussion.²⁴³ Some commentators go even further and argue that the comparative advantage of Chi-

²³¹ *Id.*

²³² See Business Report, *supra* note 198.

²³³ *Supra*, Part I.A.

²³⁴ *Id.*

²³⁵ See generally Sjoberg & Moore, *supra* note 4; see also GATT, *supra* note 4; see Pruzin & Rugaber, *supra* note 5.

²³⁶ 2004 REPORT, *supra* note 7.

²³⁷ Fong Mei Fong, *Pressure Grows to Curb Chinese Textiles*, WALL ST. J., Apr. 4, 2005, at A12.

²³⁸ See Accession Agreement, *supra* note 6, at 90.

²³⁹ See 2004 REPORT, *supra* note 7 and accompanying text; China's WTO Record: A Two-Year Assessment, Testimony Before the U.S. Chamber of Commerce Trade Policy Staff Committee (2003) (statement of Myron A. Brilliant, Vice President of the U.S. Chamber of Commerce (Asia)).

²⁴⁰ See Accession Agreement, *supra* note 6, sec. 15 (stating that other WTO members can treat China as a non-market economy in dumping and subsidy cases for fifteen years after its entry).

²⁴¹ See ATC, *supra* note 3 (referring to Chinese banks and "thousands" of state-owned companies).

²⁴² *Id.* (Noting among others that Chinese "major banks aren't banks so much as financing arms of the government" and that there is corruption in the financial system).

nese textiles is nothing more than the heavy subsidization by the Chinese government of the country's textile industry.²⁴⁴

Nonetheless, this is exactly what comparative advantage theory predicts or presupposes for the full benefits of free trade. Comparative advantage predicts that production shifts to those who can produce with the least cost.²⁴⁵ When comparative advantage works, some industries prosper while others die.²⁴⁶ Production will shift to those countries that can produce at lower costs and as a result those countries' exports will increase. The WTO framework is based on this very principle of market functioning for its members to achieve economic growth and prosperity from free trade.²⁴⁷

C. The Implications of Invoking the SCM Agreement Against Chinese Textiles for the WTO Trade System

Increased Chinese textile exports do not necessarily have primarily negative consequences. Although the Chinese dominance in the production of textiles will worry countries with "endangered" (i.e. small) textile industries, it does not mean that the implications of China's dominance in textiles are necessarily negative. Consumers benefit from cheaper clothes because of lower production costs.²⁴⁸ Moreover, commentators argue that it was the existence of quotas that created the textile industries in some developing countries and, thus, it is normal for those industries to disappear once the quotas vanish.²⁴⁹ In addition, some argue that there can still be some developing countries with special advantages, including bilateral textile agreements.²⁵⁰

The concerns surrounding the expiration of the ATC are not new. WTO countries anticipated that the expiration of the quota system in textiles would cause an

²⁴³ *Id.*, China's WTO Record: A Two-Year Assessment, Testimony Before the U.S. Chamber of Commerce Trade Policy Staff Committee (2003) (statement of Myron A. Brilliant, Vice President of the U.S. Chamber of Commerce (Asia)).

²⁴⁴ THE AMERICAN TEXTILE MANUFACTURERS INSTITUTE, *supra* note 220, at 12 (2005) (arguing that China has an enormous advantage in textiles because of its subsidies not because of its cheap labor); Jonathan Steiman, *Expiration of Textile Quota Act Takes Toll on U.S. Manufacturers* (Jan. 13, 2005), <http://pf.inc.com/criticalnews/articles/200501/textiles.html> (quoting Lloyd Wood, spokesman for the American Manufacturing Trade Coalition, who says that "it's subsidies that's really getting China the market share").

²⁴⁵ See *supra* Part II.A.

²⁴⁶ Joel R. Paul, *Do International Trade Institutions Contribute to Economic Growth and Development*, 44 VA. J. INT'L L. 285, 300 (2003) (stating that "when comparative advantage works, it necessarily means that some industries prosper while others die. In a free market, 'creative destruction' through competition ensures that productive resources shift to their highest and best use").

²⁴⁷ See Understanding the WTO, *supra* note 13 and accompanying text.

²⁴⁸ See Lim, *supra* note 220 (discussing that "some developing countries may also have special advantages that set them apart of the competition" and gives the example of Cambodia, Mexico and several African and Caribbean countries).

²⁴⁹ *Id.*; see also An End to Global Textile Quotas: Watch China Sew Up the Market, available at <http://knowledge.emory.edu/index.cfm?fa=viewArticle&id=856> (last visited Apr. 2, 2005).

²⁵⁰ See Lim, *supra* note 220.

adjustment in the textile markets and the textile industries.²⁵¹ Such adjustment is taking place now: some market shares increase and others decrease, certain domestic industries shrink and others expand.²⁵² WTO countries needed fifteen years of extensive negotiations with China before accepting it as a full WTO member.²⁵³ One of the primary issues during those negotiations was China's comparative advantage in textiles.²⁵⁴ It is not a new development for the WTO that China holds a dominant position in the textile sector or that it is an enormous and fast-growing economy.²⁵⁵ Likewise, it is not news that the Chinese economy is currently undergoing significant changes in order to transform to a market economy and that it still has some subsidization mechanisms in place.²⁵⁶ WTO members have long been aware of China's comparative advantage in the textile industry and their concerns were addressed in the special safeguard provisions of the China Accession Agreement.²⁵⁷

The reaction of the WTO to the current evolution in the global textiles market has a strong signaling effect regarding the strengths and weaknesses, and the benefits and drawbacks of the WTO framework. The developments in the international textiles trade resulting from the operation of the comparative advantage principle seem overwhelming to many countries and there is a significant risk that the speculation following the expiration of the ATC will spur protectionist pressures.²⁵⁸ However, by joining the WTO, members consented to the operation of the comparative advantage principle. They even made sure that China's Accession Agreement would provide enough safeguards to address potential import surges. Using SCM in addition to the provisions of the China Accession Agreement against Chinese textiles can only be a protectionist sign with negative implications and should not be used against Chinese textiles at this stage.²⁵⁹

Invoking the SCM agreement for further protection of WTO countries' domestic textile industries from Chinese textiles would impair the free-trade system. In defense of its textiles, China may argue that Chinese textiles displace other countries textiles not because of the subsidies, but because of its comparative advan-

²⁵¹ Godfrey Yeung & Vincent Mok, *Does WTO Accession Matter for the Chinese Textile and Clothing Industry*, 28 CAMBRIDGE J. OF ECON. 937 (2004).

²⁵² Business Report, *supra* note 198 and accompanying text.

²⁵³ Yeung & Mok *supra* note 250, at 937.

²⁵⁴ *Id.* at 938 (stating that China is the largest producer and exporter of textiles since 1995 and its accession to the WTO would have tremendous implications for the development of the textile industry globally).

²⁵⁵ *Id.*

²⁵⁶ See Accession Agreement, *supra* note 6 and accompanying text.

²⁵⁷ See *supra* Part II.C.

²⁵⁸ See generally Sjoberg & Moore, *supra* note 4; see also GATT, *supra* note 4; Pruzin & Rugaber, *supra* note 5.

²⁵⁹ See China Hails WTO's End to Textile Quotas from 2005 (29/9/04), <http://www.china-embassy.org/eng/gyzg/t162891.htm> (noting that replacing quotas with new forms of protectionist measures would negatively affect broader cooperation among WTO members, the next round of WTO trade talks and China's fulfillment of its obligations).

tage.²⁶⁰ If comparative advantage theory and its effects become the question in an SCM dispute, the entire WTO free-trade system would come into question because the comparative advantage principle lies at the heart of the WTO.²⁶¹ The DSB would become a forum of intense debate about the advantages and disadvantages of comparative advantage, and thus of free trade. The very possibility that arguments against the free-trade system will arise in the dispute process will discredit not only the dispute settlement process, but also the entire WTO legal framework.

Furthermore, using the SCM provisions against Chinese textile subsidies, despite the WTO policy concerns in support of member economies in transition, may create more problems than it would resolve. Articles 27 and 29 express the WTO's policy of providing flexibility and support to its members in the process of transformation to market economies.²⁶² Even though these Articles provide for the imposition of SCM remedies to Chinese textile subsidies in the form of preferential access to loans, it may be hard to impose such remedies without undermining their underlying policy objectives. In addition, a potential use of Article 29 for SCM measures against Chinese subsidies may have a spill over effect to subsidies of other non-market economies by creating a precedent.²⁶³ It is likely that a series of new disputes under Article 29, inspired by a successful application of the SCM against Chinese textiles, would discredit WTO's policy in support of member economies in transition, would invite criticism of the benefits of joining the free-trade system, and consequently, would undermine the WTO system.

The Accession Agreement more appropriately responds to the current situation in the world textile market than the SCM. WTO countries can place safeguards on the products that cause injury to their domestic textile industry without the risk of undermining the entire WTO free-trade system. The SCM Agreement could potentially offer a better solution if China was a full-market economy or if likeness of products could be more easily ascertainable. At the present stage, neither of these qualifications can be met: China's transition from a non-market to a market economy needs time to be completed despite the steps already taken in that direction; and since most textile production is already taking place in China, it might be difficult for a country to show that it has like products produced domestically and not imported from third countries as required in order to invoke the SCM.

Consequently, an SCM challenge may bring into question the operation of the comparative advantage principle, thus, raising doubts about the efficacy of the free-trade system itself. Therefore, instead of stopping China's textile domi-

²⁶⁰ China's comparative advantage is distinguishable from the potential effect of the subsidies to its textile industry. It might have helped the Chinese textile industry that subsidies were in place, however, China's comparative advantage does not flow from its subsidization but from its vast resources. See *supra* Part III.A., B.

²⁶¹ See Understanding the WTO, *supra* note 13 and accompanying text.

²⁶² See *supra* Part III.A.2.

²⁶³ See Quinn, *supra* note 133 (noting the lack of WTO jurisprudence on SCM Article 29).

nance, invoking the SCM in addition to the provision of the Accession Agreement against Chinese textile imports may endanger the WTO system itself.

V. Conclusion

China has a comparative advantage in the production of textiles and is the world's largest textile exporter. Consequently, China has a competitive edge in the textile industry following the elimination of all textile quotas with the expiration of the ATC. WTO countries, faced with the prospect of a Chinese dominance in textile markets, have legitimate concerns about the future of their domestic textiles industries and look to the WTO framework for solutions. China's Accession Agreement provides safeguard mechanisms which WTO countries may use to respond effectively to Chinese textile export surges. At this stage, invoking the provisions of the SCM to slow down Chinese textile exports, however effective, would be in addition to the provisions of the Accession Agreement, would discredit WTO policy concerns with respect to members with economies in transition, and would infringe on the operation of comparative advantage in the textiles market, thereby undermining the WTO free-trade system.