

# Revisiting China's market economy status: state capitalism within the WTO liberal trading system

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## Abstract

*This paper examines the question of China's compliance with market economy principles. China has reformed away from central planning in the past four decades, but has it achieved a fully-fledged market economy? The paper sheds new light on the contested nature of China's market economy status from a political economy perspective. It draws on the Varieties of Capitalism analytical framework to posit China's market economy status as the product of its national model of state-dominated institutional complementarities between high levels of trade openness and domestic regulation, including nonmarket principles for the deployment of financial resources and labour.*

**Keywords:** China, socialist market economy, WTO, Varieties of Capitalism

## Introduction

In 2021, China marked the 20<sup>th</sup> anniversary of its accession to the World Trade Organisation (WTO). Throughout the last two decades, the country has managed to greatly amplify its share in global GDP – from 3.9% in 2001 to 17.4% in 2020 – in parallel with intensifying its participation in world merchandise trade to reach a share of 13.1% (an increase of 9.1 p.p.).<sup>1</sup> China's remarkable economic progress has led to lifting several hundred million people out of poverty (World Bank, 2013) and the emergence of a burgeoning middle class. Yet this outcome was achieved in the framework of a state-driven economic model that has raised concerns among stakeholders in the global economy about China's compliance with the multilateral trading system and the existence of a level playing field in international trade.

China's WTO Accession Protocol required the country to implement market-oriented reforms. A 15-year transition period under Article 15 was considered sufficient to complete the process. It was expected that WTO members would no longer designate China as a non-market economy (NME) after December 2016.<sup>2</sup> The country has reformed away from central planning in the past four decades, but has it achieved a fully-fledged market economy (ME) status? This question cannot be reduced to a technical issue, as there is no commonly agreed-upon definition of a ME. The WTO

<sup>1</sup> Authors' calculations based on UNCTAD data, various years.

<sup>2</sup> Article 15 of China's WTO Accession Agreement allowed WTO members to treat the country as an NME in anti-dumping investigations during the transitional period.

does not grant its members market economy status; there are no institutionally agreed-upon guidelines or specific criteria for defining one. Furthermore, the WTO does not possess a centralised enforcement mechanism for imposing trade remedies or monitoring determinations of subsidies and other violations of market principles. Each WTO member uses its own criteria. More than eighty countries recognise China as a market economy, including New Zealand, Australia, Peru, Chile, and South Africa (Hošman 2021: 3). In contrast, the European Union (EU) and the United States, influential actors in the global economy, have refused to grant that recognition upon the expiration of Article 15 of China's Accession Protocol in 2016, prompting China to file a lawsuit at the WTO.<sup>3</sup> As the EU and the US continue to treat China as a NME in their anti-dumping investigations, the problem of China's compatibility with WTO market principles has important implications for the reliability of the norms governing global trading practices.

Empirical studies vary in their conclusions about China's compliance with the rule-based system of international trade. Observers have argued that China's state-led economic model represents one of the biggest challenges to the WTO-based liberal order (Ezell, 2021; Hošman, 2021; Pelkmans, 2018). The EU has labelled China a "systemic rival" and has amended its anti-dumping policy in order to address more effectively market distortions caused by state intervention (EU, 2017). The US has engaged in tariff increases and signed a bilateral Economic and Trade Agreement with China (the 'Phase One' Trade Deal), which contains a requirement for China to implement structural reforms and other market-oriented changes to its economic and trade regime (Office of the US Trade Representative, 2020; 2022). Others acknowledge China's right to keep its policy space for legitimate development purposes (Rodrik, 2018). Weinhardt and ten Brink (2020) have found that since its accession to the WTO in 2001, China has not significantly challenged the liberal order. This assessment is informed by a liberal institutionalist perspective whereby China is seen as an actor interested in an open trading system – itself open for contestation – that operates pragmatically within the existing set of rules. China itself has claimed that it "firmly observes and upholds WTO rules and supports the multilateral trading system," and remains committed to further developing its model of "a socialist market economy with Chinese characteristics" (State Council of the PRC, 2018). While China has the freedom to choose the economic system that best matches its specific circumstances and needs, its participation in international economic exchange affects economic actors operating in different market contexts (Taube & Heiden, 2015). The liberal foundations of world trade may thus be open to contestation, in case nonmarket principles, associated with China's unresolved status as a trading power, gain precedence over the premise of comparative advantage in international trade.

It is against the background of the discrepancy between public portrayals and scholarly assessments of China's participation in the international trading system that this paper sets out to re-examine the controversy associated with China's market economy status. We draw on the Varieties of Capitalism (VOC) analytical framework (Hall & Soskice, 2001), in order to shed new light on the conflicting duality of China's trade openness

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<sup>3</sup> WTO (2020) provides a summary of China's complaint. Following the EU's and US's determination for China as a non-market economy for the purpose of anti-dumping proceedings, China launched a complaint against them at the WTO. It pursued the case against the EU. The WTO Dispute Settlement Body established a Panel in 2017. Due to the complexities of the legal issues covered in the dispute, the work of the panel was delayed. In May 2019, China requested that the panel suspend its proceedings. The authority of the panel expired 12 months after its work was suspended.

and its state-dominated socialist market economy and demonstrate the unbalanced nature of the state/market relationship in China's political economy. The paper examines the institutionalised complementarities between trade liberalisation and nonmarket principles of economic governance, suggesting that China simultaneously acts as a market economy with regard to its merchandise trade and resists market reforms with regard to domestic market access, factor deployment, and industrial policy with significant effects on its global trading practices.

Empirically, the paper conducts analysis of comparative market data against the background of the institutional complementarities of China's national political economy – capital, labour, and innovation – as determinants of its international competitiveness. We approach the question about the compatibility of China's hybrid economy with the world trading system from two mutually complementary perspectives. First, we apply a dynamic setting, tracing whether China's trade policies have evolved along a market-friendly trajectory over time. Second, we examine institutional complementarities between key measures of China's socialist market economy, in order to establish its relative proximity or distancing from (neo)liberal economic principles.

The paper is organised as follows. The next section deals with the criteria for a market economy applied by the EU and the US in the context of the international trade regime. Next, we look at key measures of China's progress towards a market-based economy within the WTO's embedded liberalism continuum that allows member states to maintain a national mix of socially-oriented market regulation and external trade openness. We then expand the analytical scope of China's international performance by exploring institutional complementarities within its domestic political economy from a VOC perspective. We examine measures benchmarking China's economy in key areas, such as financial system liberalisation, market competition, innovation, trade and investment openness, and regulatory restrictiveness against leading open-market economies. The paper presents conclusions with regard to the stability of China's economic model beyond the conventional understanding of a continuum of market-enhanced systems under WTO trade rules.

## **China's market economy status: Analytical and empirical perspectives**

When the General Agreement on Tariffs and Trade (GATT), a forerunner of the WTO, was created in 1947, it established no rules for assessing the market economy status of a country. The founding members assumed that all members would adhere to the principles of the liberal economic order; however, this assumption remained implicit and such a requirement has never been rendered into legal language in GATT/WTO agreements (Mavroidis & Sapir, 2019). Even the OECD, the economic organisation of countries committed to democracy and market liberalism, has not proposed a definition of the term, its attributes, and measurement.

The experience of the post-WWII Western welfare state has shown that the background liberal principles of international trade are compatible with a variety of market systems embracing social values. The WTO-based world trading system thus represents an evolving compromise between the desirability of open markets and justifiable state intervention, yielding a model of "embedded liberalism" as an institutionalised liberal market with active public management of the economy

(Ruggie, 1982; Helleiner, 2019). “Embedded liberalism” has many faces reflecting economic governance and transnational interaction, structured by means of institutional complementarities and resulting in relatively coherent patterns of international competitiveness.

Since its beginnings, the multilateral trade regime has allowed countries with economic systems different from liberalism to join it. The WTO (and previously, GATT) confirms the right of the member states to determine the features of a market economy themselves. Such was the case of the command economies of Yugoslavia (1966), Poland (1967), Romania (1971), and Hungary (1973). Their centralised command economies were traditionally classified as NMEs.<sup>4</sup> The incompatibility of the former communist countries with market economy principles was managed through accession protocols that imposed on them certain obligations.

The lack of clearly defined and commonly agreed criteria is associated with a lack of transparency, arbitrariness, and prevalence of political motives in the designation of market economy status. This, for example, was the case with Russia (Popescu, 2010). It was originally recognised as a market economy in 2002 by the United States but in 2021, its status was placed under review. The US Department of Commerce recognised Kazakhstan as an effective market economy in 2002, while the EU continued to consider it as a “non-market economy regime” (Eicher, 2004). When China joined the WTO in 2001, Article 15 of its Accession Protocol determined that in order not to be considered a non-market economy in anti-dumping proceedings, China had to establish “under the national law of the importing WTO Member, that it is a market economy, (...) provided that the importing Member’s national law contains market economy criteria as of the date of accession.” Thus, there is a great deal of divergence in the criteria for a market economy from one WTO member to the other.

In the context of its growing participation in global trade flows, China marks perhaps the broadest divergence of views on status determination within the WTO, as both the EU and the US – China’s principal trading partners – have declined to recognise it as a market economy. Consistent with WTO practices, the EU and the US use their own criteria for determining China’s market economy status. Table 1 below demonstrates that the EU applies stricter criteria, since it focuses on the liberalisation of all prices, not just wages as the US does. The EU’s criteria include the existence of an effective business framework for the conduct of business. This is absent from the US criteria, which in turn include market access for foreign direct investment. Both sets of criteria emphasise the importance of a free exchange-rate regime and minimal state intervention in the economy.

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<sup>4</sup> US federal law defines a NME as “any foreign country that the administering authority determines does not operate on market principles of cost or pricing structures, so that sales of merchandise in such country do not reflect the fair value of the merchandise” (19 U.S.C. § 1677(18)(A)). The US list of NMEs includes Armenia, Azerbaijan, Belarus, China, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, Uzbekistan, and Vietnam.

**Table 1: EU and US criteria for determining China's market economy status**

Criteria	US Department of Commerce	EU Commission
<i>currency</i>	convertibility to currencies of other countries	degree of discrimination in the trade and currency regime
<i>wages</i>	wage rates determined by free bargaining	limited government influence
<i>foreign direct investment</i>	permission of joint ventures or other investments	---
<i>control of resources</i>	the extent of government ownership or control of the means of production	limited government influence over the allocation of resources and decisions of businesses ((limited state control, no state-fixed prices))
<i>price controls and output</i>	the extent of government control over the allocation of resources	
<i>corporate governance</i>	---	transparent and non-discriminatory company law
<i>effective legal framework for the conduct of business</i>	---	a full set of bankruptcy, property and intellectual property laws
<i>finance</i>	---	existence of a well-developed financial sector operating independently from the state, subject to adequate supervision and capital provision
<i>other factors</i>	additional factors considered appropriate	absence of state interventions in privatised enterprises

Source: Compiled by the authors based on 19 U.S.C. § 1677; European Commission (2015).

Note: Starting in 2017, the EU no longer maintains a list of nonmarket economies. The EU has amended its anti-dumping laws to apply an alternative method of calculating normal prices, based on a representative list of countries at a similar level of development with the country object of anti-dumping measures (European Union, 2017).

It is a widely held conclusion that these criteria are too general and therefore not directly measurable. They are not rank-ordered, nor do they provide any guidance as to how they should be weighed (Bowman et al., 2010). The determination of a market economy status is further complicated by the fact that there is no template for a perfectly liberal economy. The notion of what lies within the remit of a market economy is also subject to change. Prior to the 2000s and especially prior to the 2008-09 global financial crisis, it was unusual for a developed industrialised country to pursue industrial policy. Following the crisis, industrial policy initiatives have become common both for developed and developing countries. Lockridge (2014) notes that the application of remedies due to the lack of recognition of a market status for China on behalf of its principal trading partners represents a distortion of international trade. The surrogate method of calculating a product's normal value in anti-dumping procedures against China (rather than a direct nationally-based determination) does

not account for the actual structure of China's comparative advantage, such as a low-cost and skilled labour force, flexible regulations, and efficient logistics.

Although China defines itself as a socialist market economy with Chinese characteristics and posits full adherence to WTO market rules and principles, its status as a market economy is neither theoretically necessary nor automatically ensured by the sheer size of its global transactions. China's transition from a command to market economy is a long and continuous process that rarely has a distinct end point. Market-oriented reform started in 1979, a decade earlier than in the countries from the former Eastern bloc. Unlike the Eastern European countries that followed a model "shock therapy", China's approach to market reform has been gradual (King, 2007). It is widely acknowledged that the prudent and sequenced transformation process has produced impressive economic growth in China in comparison to the countries in Central and Eastern Europe (Pogátsa, 2021). Furthermore, the construct of a socialist market economy does not conceptualise a static coherent structure but rather a system in constant flux between more or less market, intervention, and regulation, shaped by domestic and international events and developments (Bekkevold et al., 2020, p.15).

China's role in global supply chains has expanded significantly. Its trade surpluses with key stakeholders in the international trading system have increased as well. The share of exports to China for the trade balance and economic growth of the EU and the US has continued to grow. Both the EU and the US depend more on Chinese inputs for their exports, while China relies less on EU and US goods for its own exports. Trade data reveal that from 2000 to 2018, the EU's trade deficit with China increased from USD 49 billion to USD 300 billion, equivalent to roughly 2% of EU GDP. The US goods trade deficit grew from USD 83.0 billion in 2001 to USD 367.2 billion in 2015, or 11.2% annually. It stood at USD 310.3 billion in 2020. In parallel with its growing participation in international trade, China has pursued trade liberalisation, consistent with WTO trade practices and reflected in declining levels of import tariffs, no notable manipulation of the exchange rate of the currency, the Chinese yuan, and levels of government spending in line with or even below similar development-oriented economic systems.

Prior to China's WTO accession in 2001, its average effectively applied tariff was 14.7%. By 2020, China's import tariffs had decreased almost 6 times to 2.5%. Table 2 demonstrates that although higher than the tariffs applied by the EU (1.5%) and the US (1.5%), China's progress toward trade liberalisation has been significant.<sup>5</sup> The share of tariff lines with international peaks in China's foreign trade has declined as well. While such peaks affected over 42% of Chinese tariff lines in 2000, in 2020 they were consistent with levels reported by the other two major trading powers, the EU and the US.

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<sup>5</sup> The average tariff rate applied by the US in 2019 (13.8%) was much higher due to the punitive tariffs unilaterally imposed by former President Trump under Section 301 (against nations engaging in unfair trade practices) and Section 232 (against imports that threaten US national security). While China retaliated immediately, that did not affect its applied tariff rate as much as it did in the US, where data is skewed given the higher share of Chinese imports into the US over US imports into China.

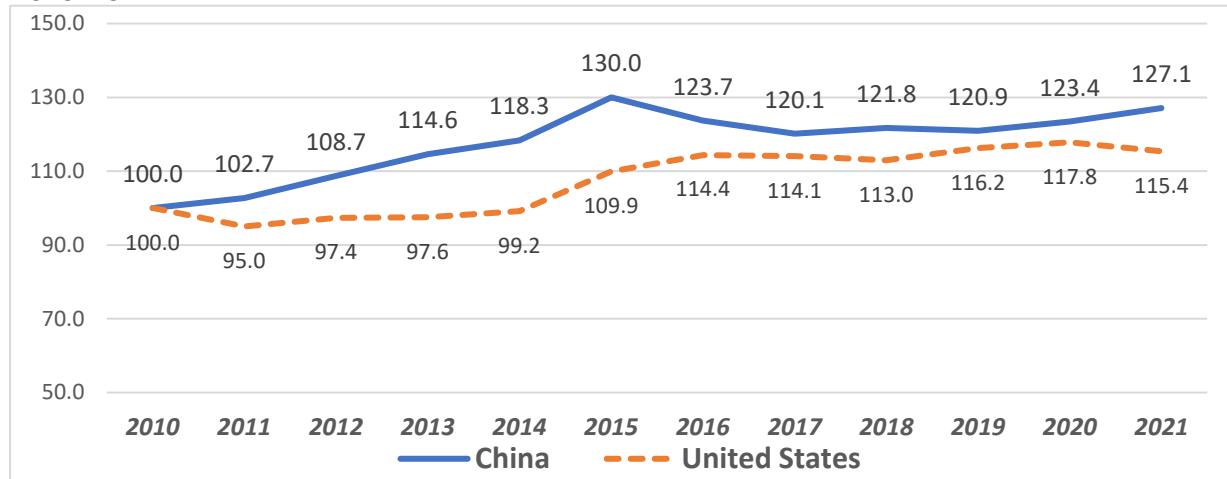
**Table 2: Tariff rates applied by China, the United States, and the EU**

Country	Indicator	2000	2010	2019	2020
CHINA	Tariff rate, MFN, simple mean, all products (%)	17.0	9.7	7.5	7.6
	Share of tariff lines with international peaks, all products (%)	42.4	11.3	1.8	1.7
	Tariff rate, applied, weighted mean, all products (%)	14.7	4.7	2.5	2.5
USA	Tariff rate, MFN, simple mean, all products (%)	4.2	3.7	10.2	3.5
	Share of tariff lines with international peaks, all products (%)	8.7	5.5	5.8	5.7
	Tariff rate, applied, weighted mean, all products (%)	2.1	1.7	13.8	1.5
EU	Tariff rate, MFN, simple mean, all products (%)	6.2	5.6	6.2	4.3
	Share of tariff lines with international peaks, all products (%)	5.6	5.4	5.7	1.8
	Tariff rate, applied, weighted mean, all products (%)	2.4	2.1	1.8	1.5

Source: World Bank (2022).

China's exchange rate policy has supported the goals of trade liberalisation. At the time of writing, effective since June 2018, China's de facto exchange rate regime has been classified as a type of "managed arrangement". The value of the Chinese yuan is determined with reference to a basket of currencies. China considers changes in its exchange rate regime a part of the overall economic reform that has to be implemented gradually and incrementally, in order to avoid a major financial crisis. In 2017 the People's Bank of China introduced a counter-cyclical factor into the daily trading band's central parity formation (phased out in 2020) which stabilised the yuan exchange rate at a reasonable and equilibrium level (WTO, 2021). According to the International Monetary Fund, China's real effective exchange rate is broadly consistent with its economic fundamentals (IMF, 2017). Data on the real effective exchange rate of the Chinese yuan in Figure 1 show that it has appreciated by 27.1% over the period 2010-2021. That is a higher appreciation in comparison with the US Dollar, which over the same period has appreciated by 15.4%.

**Figure 1: Real effective exchange rate index (2010=100) for China and the United States, 2010-2021**

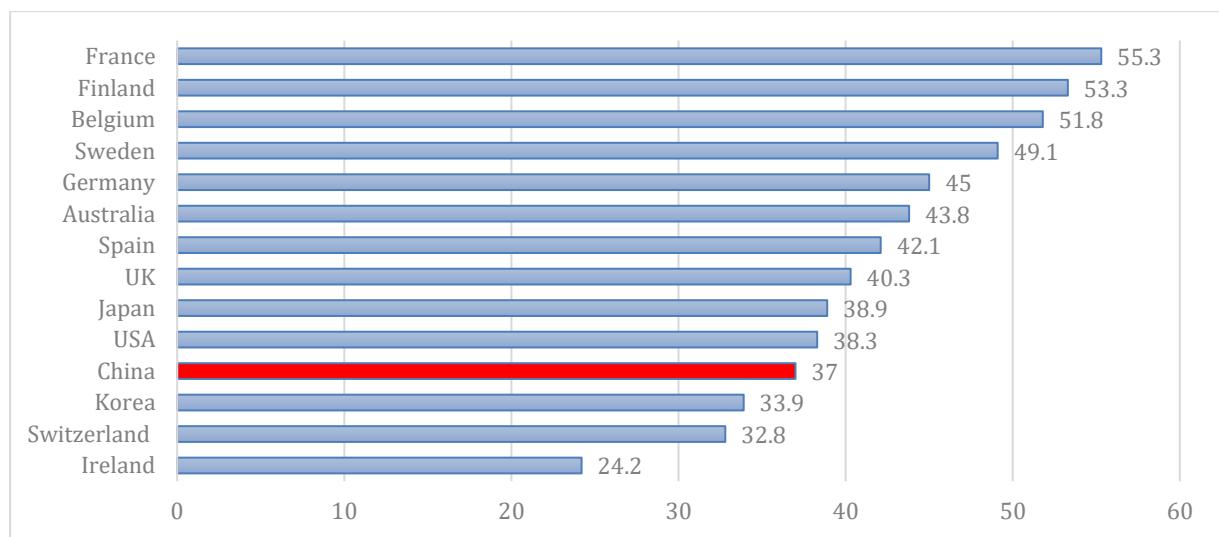


Source: World Bank (2022).

The trend of real effective exchange rate appreciation of the Chinese yuan over the extended timeframe observed above means that China is losing its comparative cost advantage. The data suggest that the country does not manipulate the exchange rate of the yuan in order to obtain an unfair competitive edge and stimulate its exports.

According to government spending, an indicator of the size of the state and its role in the national economy, China's public expenditures as a share of its GDP are lower than those of a number of OECD countries, which is at odds with its definition of a socialist market economy. The data in Figure 2 show that China is closer to the liberal market economies of the US, Switzerland, and the Republic of Korea than to the social market economies of Western Europe.

**Figure 2: Total general government spending, % of GDP (2019)**



Source: OECD (2022a). Data for China is for 2020, quoted in from Knoema (2022).

Notwithstanding China's evident progress in the area of trade liberalisation, import tariffs represent just one of the tools of its trade policy. With tariffs continuously declining on a global level, Non-Tariff Measures (NTMs), which represent requirements applied at the border or behind the border to traded goods, have become

even more important in determining trade patterns over the years. Unlike tariffs, NTMs are not transparent. In some cases, they pursue straightforward protectionist goals; in others, NTMs are indispensable for achieving pivotal socio-economic objectives as they aim to protect human, animal or plant health as well as the environment (UNCTAD & WB, 2018).

China has been an active user of NTMs, with numbers exceeding those applied by its regional partners, such as the Republic of Korea, Japan, Australia, New Zealand and India. According to UNCTAD (2020), the majority of China's NTMs (59.5%) constitute technical measures related to technical specifications, quality requirements, and consumer safety, most of which are in line with recognised international standards agencies, for example, the ISO and the IEC. In addition to technical measures, the second largest group of NTMs (22.5%) pertains to non-discriminatory SPS measures that ensure food safety and prevent the spread of pests and diseases into the country (UNCTAD, 2020, p. 32).

While the usage of NTMs is not necessarily trade restrictive and could in many cases be attributed to legitimate societal goals, China has often been accused of using implicit trade embargos and sanctions weaponising its trade policy for foreign policy purposes. Cases of trade coercion include Japan in 2010, Norway in 2011, Philippines in 2012, Mongolia in 2016, Taiwan in 2016, the Republic of Korea in 2017, Canada in 2019, and Australia in 2020 (Wilson, 2021). China's coercive behaviour during diplomatic disputes has worsened its image among its regional trade partners hindering its recognition as a market economy.<sup>6</sup>

Such indicators reveal the incomplete and contradictory nature of China's trade openness. There are therefore significant problems with the conventional lens of examining the nature of China's economy based on its trading practices alone. China's international performance is not only a product of tariff levels, exchange rate management, and trade-offs between its domestic social policies and external market openness. Pelkmans (2018) has argued that the Chinese model represents a systemic issue for international trade, associated with its highly interventionist nature. Horn et al. (2019) find that domestic variables and geopolitical priorities drive China's capital flows. Corporate investment is not exclusively determined by economic rationale, such as yield and return on investment principles, but depends on state intervention and reflects state dominance in market transactions. However, the overall openness of the economy and adoption of market incentives domestically tends to obscure its state-driven nature and continued need for reform. China's positioning itself as a market economy of a socialist type with Chinese characteristics, despite aggregate indicators of trade liberalisation, such as import tariffs, exchange policy, and government spending, is thus insufficient to account for the determinants of market outcomes.

China's socialist market economy does not comfortably belong to the continuum of market economies under the WTO's consensus on embedded liberalism, otherwise sympathetic to the duality of social objectives in public policy and comparative advantage principles in international competition. While under the premises of a socialist market economy, the prevalence of public ownership may be expected, in

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<sup>6</sup> China is not the only actor in international trade resorting to trading practices that undermine the integrity of the rules-based trading system. Wilson (2021) and Reinsch (2021) point out that other large countries in the global economy with established liberal democratic systems have been selectively using NTBs in a non-transparent way.

China that principle is implemented in terms of domination and control by the state, no reciprocity for foreign firms in the area of government procurement, forced technology transfers, and forced localisation of production, reflected, for example, in the “Made in China 2025” industrial strategy. Moreover, such policies, institutionalised within a centralised system of control, are mutually aligned and interlocking along multiple dimensions in industry, banking, innovation, technical standards, investment, and consolidated into a state-dominated economic system. According to Ezell (2021, p. 6), such policies represent the workings of a model of state-led capitalism.<sup>7</sup>

Similarly, it would be misleading to interpret the term ‘socialist’ in terms of ‘socially oriented outcomes’, conventionally associated with the ‘social market’ economies of the West-European countries. The objective of China’s economic system (as in other similar models in Asia) is socialism in society, not necessarily the maintenance of a market environment of the economy (London, 2020). For this reason, it may be argued that positing China’s market economy as a part of the continuum obscures other, more profound features of its economic model, such as state intervention or the objective of a state-dominated social order.

Given the complexity of the issue associated with defining a market economy, the lack of clear-cut criteria, and existence of diverse models of economic governance, the compatibility of China’s socialist market economy with the liberal economic order needs to be examined by taking into account the structural conditions of its domestic economic system. Variables linked to domestic activity and economic governance may be better positioned to explain the scope and time horizon of China’s trade liberalisation.

## **The domestic determinants of China’s market-economy status: A Varieties of Capitalism (VOC) approach**

The proposition about the path-dependent interaction between market and nonmarket principles underlying China’s economic competitiveness pertains to the VOC theoretical framework exploring institutional complementarities in the domestic political economy.

The VOC perspective is relevant to institutional and policy developments related to trade performance (Hall & Soskice, 2001; Hancké et al., 2008, among others). It makes several analytical claims: (1) about the multidimensional nature of institutional complementarities; (2) about the mutually reinforcing effects of trade policy, enterprise governance, and international performance; (3) about their common premises within the respective national economic models of finance and state-enhanced capitalism; and (4) about the importance of selective institutional innovation to national adjustment and competitiveness.

VOC has not been discussed in connection with China’s market economy status, although it posits international performance as a product of path-dependent

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<sup>7</sup> The proposition that China represents a system of state capitalism is widely shared in the literature. See also Beeson (2009), Bekkevold et al. (2020), Pelkmans (2018). Similarly, McNally (2012) defines China’s political economy as “Sino-capitalism”. Zhang (2008) suggests that it represents “capitalism with Chinese characteristics”. Peck and Zhang (2014) examine China’s “polymorphic” system in terms of a bifurcated and variegated variety of state capitalism.

institutional complementarities, creating deep and persisting differences among national economic systems. As Peck and Zhang (2013; 2014) have argued, China's national political economy model is contradictory. London (2020) similarly concurs that the conventional VOC framework is too rigid; remains static; and does not cover hybrid cases, such as China's economic system.

The VOC framework holds that the path-dependent institutional complementarities emerging between systems of industrial relations, long-term employment, financial systems of capital provision, contract law and inter-firm collaboration create different comparative institutional advantages (not simply 'comparative advantages' based on price and costs differentials in international trade) resulting in different patterns of international performance. Conventionally, countries cluster around several ideal types of financial and industrial systems: liberal market economies (LMEs) that rely on markets to coordinate firm endeavours and state participation in the economy; coordinated market economies (CMEs), characterised by institutions reflecting higher levels of non-market coordination; the distinct Nordic model of capitalism, which maintains institutionally sustained high level of employment and economic growth; and the mixed market economies (MMEs) that rely on a larger agrarian sector and histories of extensive state intervention, resulting in various capacities for non-market, state-dominated coordination in the sphere of corporate finance and selective more liberal arrangements in the sphere of industrial relations (Hall and Soskice, 2001, p. 21). Typical of East-European systems is the second-generation model of dependent-market economies (DME), characterised by dependence on international value chains controlled by Western multinational companies, in contrast to national capital markets and inter-firm networks. It features low wages, weak trade unions and low taxes, necessary to continue to attract foreign direct investment (Pogátsa 2021).

There is a vast and growing literature on the foundations of China's model of state capitalism and the relationship between state and market in China's model of a socialist market economy (Bekkevold et el., 2020; Pearson et al., 2021, among others). China's trade strategy, characterised as an outward-looking, export-led, and globally-oriented approach, represents a resource for domestic economic development. Market and developmental principles are not clearly distinguished. Their contradictory workings and differential outcomes are due to the impact of domestic regulation over financial, investment, and market access variables over time, despite the homogenising influences of market liberalisation, reflected in the declining levels of import tariffs under the WTO trade regime.

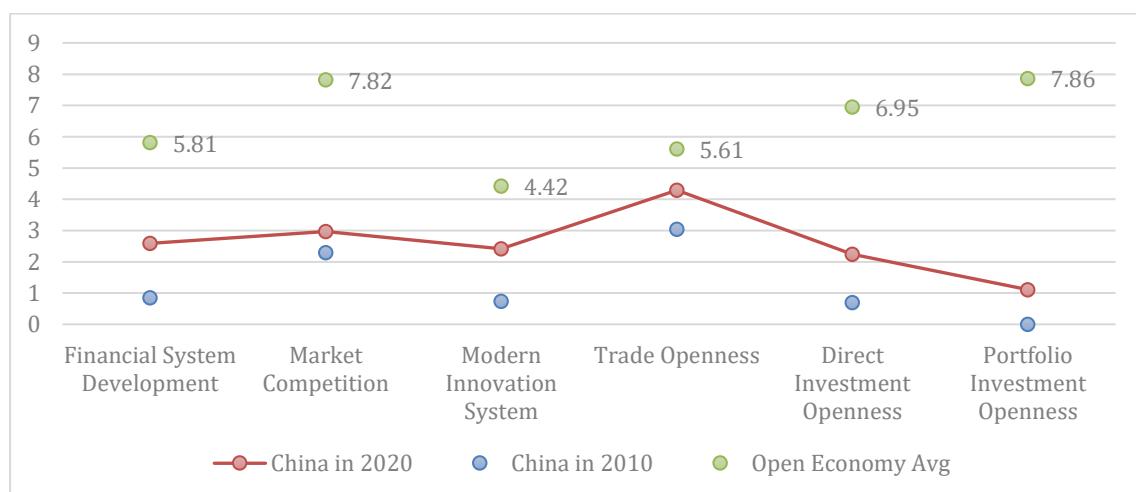
From a VOC perspective, China's socialist market economy is embedded in a model of state capitalism that relies on international value chains controlled by Western multinational companies and high levels of public investment in domestic firms, in contrast to market-based horizontal links between domestic and international sources of capital. The lack of competitive neutrality between private and state-owned enterprises (SOEs) allows for the accelerated process of national capital accumulation, centralised within the state, and the effective allocation of investment to generate high economic growth and maintain macroeconomic stability. Studies have found that Chinese SOEs benefit from a lower effective tax rate and privileged sources of financing (European Parliament, 2020). Under this model, private economic agents and domestic and international corporations are placed in a dependent position relative to SOEs as a result of sustained state intervention (Nedumpara & Zhou, 2018). Labour is a particularly depressed factor in the state-capitalism variety due to the abundance of

labour in China's economy that maintains low wages (albeit increasing in recent years), bans independent trade unions, and lacks meaningful rules of wage bargaining and labour association. From a long-term perspective, domestic innovation is also hindered (Peck & Zhang, 2013). It is concentrated within large SOEs and international corporations, often subject to forced technology transfers. There are no sustainable incentives for workers as a result of low wages and wage insecurity due to a large reserve of labour supply. China depends heavily on a banking system and finance allocation by the state. Limited market access for international corporations contributes little to innovation outside forced technology transfer, leading to weak competition in important domestic sectors associated with investment (including portfolio investment) and finance.

Given the institutional complementarities of domestic economic governance that maintains a dominant role for the state, has China moved closer or further away from the status of an open market economy? The Atlantic Council (2021)<sup>8</sup> examines six elements of the market economy model that represent institutionally complementary systems of economic governance: financial system development, market competition, modern innovation system, trade openness, direct investment openness, and portfolio investment openness. From this perspective, China's market indicators are not simply indicators of international performance but also components of an economic model that simultaneously enhances and controls market openness.

China's scores on key economic areas outlined in Figure 3 demonstrate that key economic systems of finance, investment, and market access lag behind the respective averages for MEs, with the exception of relative proximity to market-economy levels of trade openness.

**Figure 3: Benchmarking China's economic system (2010 and 2020) in key economic areas in comparison to open market economies<sup>9</sup> in 2020**



Source: Atlantic Council (2021).

<sup>8</sup> The *China Pathfinder Annual Scorecard* study explores China's economy in six areas that define open-market systems: trade, innovation, direct investment, portfolio flows, market competition, and the financial system. The data is used to generate a scoring grid comparing China's record of liberalisation and its economic performance with those of the US and nine other leading open-market economies. The authors then tracked how China has progressed on these metrics during the period 2010–2020. See Atlantic Council (2021).

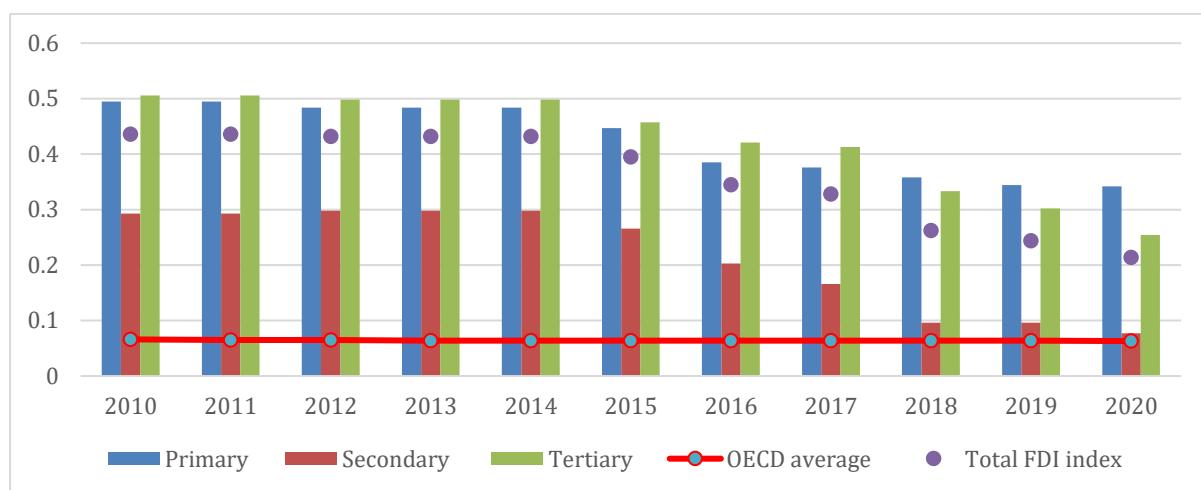
<sup>9</sup> The open-market economies selected for benchmarking are OECD member states on the top-ten country list for highest GDP. These countries are Australia, Canada, France, Germany, Italy, Japan, Republic of Korea, Spain, the UK, and the US.

The lack of meaningful approximation between China's scores and ME averages in the area of international investment and financial system development suggests that the country is not adequately positioned as a market economy. The divergence is particularly pronounced in the area of market competition, despite progress in terms of trade openness. Viewed within a dynamic perspective, however, China has moved into a positive direction over the period 2010-20, improving, albeit marginally, its performance along all the indicators.

China's industrial policies are directly affected by its state-dominated economic system. Industrial policy involves preferential treatment of certain sectors over others and intensive use of subsidies as a tool for promoting their industrial competitiveness. It is a widely shared assumption that no country can achieve structural transformation and economic development without some form of industrial policy (UNCTAD, 2016). Yet, China is often accused that its industrial policy creates significant distortions in the global economy and disrupts markets in the industrialised countries. This is especially problematic in critical traditional sectors, such as steel and aluminium, due to inefficient resource allocation conferring an unfair advantage to Chinese companies along the value chain (US Trade Representative, 2020). The two sectors produce key inputs for various other manufacturing industries and are highly relevant to national security preparedness. They were the first target of the US tariff increases in the trade conflict with China.

The problems created by the heavy subsidisation of certain industries are recognised by the Chinese government. In 2016, China's State Council introduced various measures dealing with the overcapacity in the iron and steel industry, including prohibition of building new steel capacity, proactive capacity elimination, mergers and acquisitions, restructuring, transformation and conversion of production lines, relocation and reconstruction, as well as removing "zombie companies" (State Council of the PRC, 2016). As a result, the compound growth rate of China's iron and steel trade remained negative for exports (-6%) and positive for imports (+18%) over the period 2016-20, leading to a negative trade balance of USD 3.4 billion (International Trade Centre, 2022).

**Figure 4: OECD's FDI Regulatory Restrictiveness Index for China by sectors (2010-2020)**



Source: OECD (2022b).

Note: Sector scores vary between 0 ("closed") and 1 ("completely liberalised").

China's economic development model has traditionally relied on inbound foreign direct investment (FDI). Since 2010, the country has been among the top destinations for foreign investments. Still, China does not follow a horizontal approach in its FDI policy but discriminates among industries. Figure 4 demonstrates wide regulatory divergence across China's economic sectors. In some industries, FDI are encouraged through various promotional measures, such as tax rebates, exemptions, and discounted land prices. In other industries, enlisted in the National Negative List, inbound FDI are restricted. In order to obtain market access, foreign investors in these industries have to meet a number of requirements, including state authorisation and shareholding limits. The 2020 National Negative List reflects a more recent trend of eliminating restrictions, from 63 in 2017 to 33 in 2020, in parallel with liberalisation in services, manufacturing, and agriculture (WTO, 2021).

Based on the OECD's FDI restrictiveness index (OECD, 2022b), it may be concluded that while China lags behind the average performance of developed countries, it is moving in the direction of reducing regulatory restrictions across industrial sectors. Progress has been particularly pronounced in manufacturing, where China's economy is globally most competitive at this stage.

## **Conclusion**

The paper has explored the puzzle of persisting EU and US views and official policy determinations of China as a non-market economy. It addressed the question "Is China a market economy" from a political economy perspective exploring indicators of market openness against the background of government policies in the areas of trade, exchange rate management, financial flows, investment restrictiveness, and industry subsidies that determine state competitiveness in international trade.

Analytically, the paper has shown that despite stark differences in the implementation of market principles, motivations, and state intervention in the economy, international competitiveness is not derived from clear binary categories, such as the ME/NME dichotomy, but by a continuum of economic models of state involvement in the economy that vary according to industrial sector and factor of production. The paper has contributed insights derived from the VOC framework to complement the assessment of China's model of a socialist market economy. This analysis concurs that from a VOC perspective, China represents a system of state capitalism blending a strategic share of state ownership, regulated financial flows, and regulatory restrictions for the deployment of financial resources with trade openness and international competitiveness (US Trade Representative, 2022).

On the one hand, China successfully participates in international trade liberalisation, reaching levels of economic openness commensurate with those of established market economies. On the other, while it posits itself as a responsible stakeholder in international trade, China has maintained a model of limited reciprocity in terms of market access, investment, and ownership of the economy likely to persist as rival structures of economic governance create dichotomies between state and private economic actors. China's participation in international trade is therefore amenable to replacing key tenets of market liberalism with an alternative strategy of selective restrictions of market access and state intervention in the economy.

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