

*Rare Earths*  
Student Materials

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- Decided by a WTO panel in March 2014
- Key topics: trade (protecting competing values); environment (interaction with trade law)

Learning Objectives

- Understand and apply:
  - GATT rules on quantitative restrictions
  - GATT rules on protecting competing values
- Analyze and evaluate:
  - how economic policies can generate multiple simultaneous effects
  - how international trade law constrains environmental policies

Background Information

The term “rare earth” describes seventeen different elements from the periodic table. These elements are contained in minerals that are extracted from the earth. Rare earth minerals are used extensively to produce electronic goods, including cell phones, computers, and medical devices. They are widespread geographically, but the process for extracting these minerals creates radioactive and hazardous waste.

As environmental and labor laws grew stronger in developed states, rare earth mining became more expensive in places like Australia and the US. In contrast, Chinese companies were able to continue extracting these minerals at a relatively low cost because of China’s relatively weak environmental and labor laws. Over time, most mining corporations in developed states found that they could not compete with Chinese companies. Almost all of these companies either went bankrupt or shifted to other kinds of mining, giving China a near monopoly on the production of rare earth minerals.

Because China has a state-controlled economy, it has broad domestic authority to regulate the activities of individual firms. (However, as discussed in the Panel report, it sometimes has difficulty enforcing these rules. Illegal rare earth mining and smuggling are common in China.) Beginning in 2002, China started imposing export quotas on rare earth minerals. These quotas limited the volume of goods that could be sold to foreign consumers. Then in 2006, China began to impose more extensive regulations on various activities related to rare earth minerals. By 2012, China had a broad conservation policy for rare earth minerals that included:

- Access conditions: To obtain government licenses to operate, new firms had to prove that they could extract/produce a minimum volume of rare earth products. This requirement was intended to eliminate small and inefficient firms.
- Volume restrictions: The Chinese government limited the economic activities of individual firms using three types of quotas:
  - Extraction quotas: limited the volume of rare earth minerals that were extracted
  - Production quotas: limited the processing of various rare earth minerals
  - Export quotas: limited the sale of minerals/products to foreign consumer
- Resource taxes: The Chinese government taxed various stages of rare earth production
- Environmental requirements: The Chinese government imposes various environmental regulations on how rare earths are extracted and processed

In 2012, the EU, Japan, and the US sued China at the WTO over its export quotas. China acknowledged that its export quotas broke GATT rules. However, China argued that its export quotas were justified under Article XX(g), which pertains to exhaustible natural resources. The EU, Japan, and the US agreed that conservation was an important goal. However, they argued that China's true reason for using export quotas was to promote domestic manufacturing. Namely, many firms that needed rare earth minerals to produce their goods (like cell phones and laptops) decided after 2002 to manufacture more of their products in China. This manufacturing boom greatly expanded Chinese employment and access to intellectual property.

## Relevant Legal Text

### General Agreement on Tariffs and Trade (1947), Article XX:

Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures ...

(g) relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption.

## Panel Report

### Part I: Introduction

The Panel began by summarizing the positions of the complainants—the EU, Japan, and the US—and the respondent, China. It noted that all of the disputants (including China) agreed that China had broken GATT rules on quantitative restrictions, which are contained in Article XI. However, the disputants disagreed about whether China's actions were justified by Article XX, which allows states to break GATT rules if they are protecting certain competing values.

The complainants assert that China subjects various forms of rare earths ... to quantitative restrictions, including quotas. According to the complainants, such measures are inconsistent with Article XI:1 of the GATT ... China does not dispute that it imposes export quotas on the products at issue. It also does not contest that these quotas violate Article XI:1 of the GATT ... China argues, however, that the obligation in Article XI:1 is subject to the general exceptions in Article XX of the GATT ..., and submits that the export quota measures at issue are justified under Article XX(g) of the GATT ... In the opinion of the complainants, China has failed to demonstrate that its export quotas fall within the scope of subparagraph (g) of Article XX, or that they comply with the requirements of the chapeau of Article XX ...

The Panel then discussed the role of Article XX in justifying policies that would otherwise violate the GATT.

A measure that is inconsistent with one or more obligations in the GATT ... may nevertheless be justified under Article XX ... The various subparagraphs of Article XX lay out the manner in which a member may adopt ... GATT-inconsistent measures ... For a measure to be justified under Article XX(g), the measure at issue must (i) “relate to” the “conservation” of an “exhaustible natural resource”, and (ii) be “made effective” “in conjunction” with “restrictions” on “domestic production or consumption”. The Panel notes that, although a measure’s compliance with each of these elements must be shown, Article XX(g) ultimately lays down a single test, the entirety of which must be satisfied if a measure is to be maintained pursuant to that provision ...

#### Part II: Does China’s Policy Conform to Article XX(g)?

The Panel then began to apply GATT law. The first major question was whether China’s policy conformed to Article XX(g) of the GATT. The Panel clarified that this treaty provision could be broken into two parts:

To comply with the legal test under subparagraph (g), the challenged measures must be genuinely related to, that is to say really about, conservation, and if they are, any conservation-related burden must be imposed even-handedly on foreign and domestic users ...

(a) Does China’s policy “relat[e] to the conservation of exhaustible natural resources”?

For the first part of Article XX(g), the Panel noted that the disputants agreed that rare earth ores were “exhaustible natural resources”. They disagreed, however, about whether China’s policies “relat[ed] to the conservation” of these ores. The Panel outlined the main arguments made by China.<sup>1</sup>

China has advanced [many] arguments in its various submissions which, it submits, prove that the export quota “relates to” the conservation of rare earth ores. These arguments are that [(i)] the export quota prevents smuggling and/or the export of illegally extracted rare earth products; [(ii)] the export quota reduces domestic demand for illegally extracted and/or produced rare earth products, ... [and (iii)] the export quota enables China to “allocate” the limited supply of rare earth resources ...

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<sup>1</sup> We include here three of China’s six arguments.

The Panel then examined each of these arguments in turn.

*(i) Does China's export quota prevent smuggling or the export of illegally extracted minerals?*

According to China, “the export quota system enables the Chinese authorities to trace the sources of the exported rare earth products and thus to identify illegally produced rare earth products when they are exported”. Moreover, China argues that “the quantitative restrictions embedded within the export quota system reduce incentives for domestic illegal production. By imposing a maximum limit on the amount of rare earth products that can be exported and will be satisfied by legal producers, the quota sends a signal to domestic producers that it is not worth starting up illegal mining or production”.

In its first written submission, China describes its rare earths export quota in the following way:

The export quota measures further enhance the effectiveness of China's comprehensive conservation policy by facilitating the enforcement of existing domestic production and extraction quotas in other ways ... specific export quota measures require the production of documentation that assists Chinese authorities to identify and enforce domestic production that occurs outside of permitted production and mining quotas. Thus, manufacturing enterprises that seek to export rare earth products must provide the list of the mining enterprises that are the sources of supply of rare earth raw materials, the quantities purchased and the relevant [tax] invoices and proof of sources of mining enterprises. Trading enterprises must provide the relevant supporting materials and relevant [tax] invoices demonstrating that they purchased exported rare earth products from manufacturing enterprises that meet all applicable requirements. These specific requirements are tied to and dependent on the existence of the export quotas. Their effect is to help China enforce its conservation policy by curbing rare earth production outside permitted production quotas.

According to China, smugglers sometimes use “false declarations, concealed reports of commodity names, exports from different ports in batches, and exports without proof of the legality of production or extraction” to smuggle illegally produced rare earths out of China. In China's view, the export quota, which is administered as a series of documentary and physical inspections, primarily at the point of exportation (i.e. at the border), helps China to overcome

such attempts to “circumvent and avoid the costs of China’s conservation measures”. As China explains it, “in the face of this illegal demand, China must also control at the border what quantities of the rare earth products that are exported and determine whether their origin is legal or illegal” ...

The Panel agrees with China that, in the face of such smuggling, it is important that border authorities verify the provenance of all rare earth products destined for export. Measures designed to verify that rare earths destined for export were legally sourced, and to interdict shipments of illegally produced rare earth products do, in the Panel’s view, “relate” to conservation. The Panel accepts that the various border inspections, controls, and checks that China carries out on export consignments of rare earths are appropriate for the task of interdicting consignments of illegally extracted or produced rare earth products (including products produced above quota levels). By enabling Chinese authorities to detect shipments that contain illegally produced products, or products produced by legal enterprises in excess of the extraction and production quotas, these border controls reduce the incentive for illegal or over-quota rare earth extraction and/or production, and thus help to reinforce China’s rare earths conservation policy.

The Panel fails to understand, however, why the clear need to prevent the export of illegally produced goods entails or justifies the imposition of quantitative restrictions on the amount of *legally produced* rare earth products that can be exported. While it may well be necessary to check that all rare earth products leaving China have been produced legally (i.e. within the extraction and production caps and in accordance with China’s various environmental regulations) and to stop attempted exports of illegally extracted or produced products, the Panel struggles to see how a quantitative limit on the amount of *legally produced* goods that can be exported “relates to” China’s efforts to suppress smuggling ... As the Panel sees it, policing and checking are distinct from the export quota, which simply limits the amount that can be exported from the already limited pool of legally extracted and produced rare earths. The amount of legally produced rare earth products that China allows to be exported is not connected to the goal of checking the legality of a particular shipment. Even if there were no quota, China would still need to inspect and police exports of rare earths. This suggests to the Panel that the export quota itself has nothing to do with policing and checking, even if in practice quota compliance checks and legal sourcing checks are performed by the same customs authority. To the contrary, the quantitative restriction on the volume of exports seems to the Panel to be an independent mechanism whose purpose is to control *how much* of the legally extracted and produced rare

earths leave China. However, ... the place where a resource is consumed is not relevant to the conservation of that resource. In the Panel's opinion, China has not demonstrated how a quantitative limit on exports, above and beyond documentary and physical inspection and other methods of border control, prevents smuggling or limits illegal extraction or production of rare earths ...

[Additionally,] the Panel considers that some smuggling activity takes place outside the regulated chain of commerce, avoiding customs and other border controls altogether. In such circumstances, it is difficult to see how China's export quota system will be able to intercept and prevent illegal exports or smuggling. Where a quantitative restriction involves border controls to limit the amount of *legally exported* rare earth products, it will not be capable of counteracting the risk that rare earth products will be exported outside of the regulated export quota system ...

Insofar as China's concern is to prevent smuggling of illegally produced rare earth products, the measures are overbroad since they prevent the export of *legally produced* rare earth products (above a certain absolute numerical limit), rather than just illegally produced products.

*(ii) Does China's export quota control or limit illegal extraction or production for the domestic market?*

China also argues that its export restrictions work to prevent illegal mining for sale to the *domestic market* ... China explained that:

China's export quotas support on-going enforcement efforts by further reducing incentives for illegal mining and production by removing an outlet for selling such illegal products. Indeed, by means of the quantitative export restrictions, China ensures that this export volume will be met by legal producers. Without an export quota in place, there is the potential that a significant part of all legally produced rare earth products could be exported. This could occur because of a speculative demand surge or because of governmentally-promoted foreign stockpiling. This could leave the domestic Chinese market in a supply squeeze. Because the legitimate Chinese producers cannot produce more than the assigned production quota – and there are no other rare earth supplies of any significance outside China – there would be great incentives for illegal producers to meet domestic Chinese demand. The presence of an export quota removes this additional incentive for conservation-frustrating illegal production and selling to the domestic

market. Therefore, China relies on quantitative export restrictions as part of its comprehensive conservation policy.

In other words, China argues that the export quota polices the rare earth product flow to domestic down-stream industries. By ensuring that domestic consumers receive a sufficient share of the limited rare earths supply to meet their demand, the export quota prevents a domestic “supply squeeze” that would create domestic demand for illegally produced rare earth products, and thus limits incentives for illegal production as well as over-production by legal mining and separating and smelting companies.

The Panel has difficulty agreeing with China’s argument for a number of reasons.

First, the relationship between “quantitative limits” on exports that are controlled at the border and domestic extraction and production quotas is far from clear. The export quota at issue does not contain any provision regarding any form of direct or indirect control over the amount extracted or produced legally or illegally, or over the amount of rare earth products consumed domestically. While an export quota might operate to check the source of rare earth products destined for *export*, the Panel fails to see how such export quota could effectively operate to check or “trace” the source of rare earth products being consumed *domestically*. Nor is the Panel convinced that export quotas can discourage illegal extraction and production intended for the domestic market. For the Panel, there is no connection between export quotas, which operate as a border check on goods destined for export, and domestic consumption, which takes place inside China’s own borders, far away from the border points at which the rare earth export quota is controlled. In other words, demand from the domestic market for illegal extraction or production cannot be controlled by export quotas controlled at the border.

Moreover, it seems to us that if the export quota were to operate as China claims, i.e. by ensuring that domestic consumers have access to a sufficient supply of rare earth products, incentives for illegal extraction and production might still exist if China maintains extraction or production restrictions. This concern is based upon what appears to us to be a tension inherent in China’s “comprehensive conservation policy”, and which we explain in the following paragraphs.

China argues that through its extraction and production quotas, China “intend[s] to restrict domestic consumption of newly produced rare earth products”. China has also made clear that it

attempts to set the levels of its extraction and production quotas below the expected level of domestic demand. Finally, China argues that “China’s rare earth consumers cannot purchase more newly produced rare earths than the volume obtained after deducting the export quota from the production quota”, and that the export quota therefore operates to *restrict the amount of rare earth products* available to domestic users. In sum, China argues in a variety of ways that its “comprehensive conservation policy” works to restrict the access of domestic consumers to rare earth products. In the Panel’s view, so long as the legal domestic supply is lower than domestic demand, the demand for illegally produced rare earth products would likely exist. It appears to us, then, that China’s explanation of its export quota as necessary to prevent a “supply squeeze” sits uncomfortably with its claim that a key purpose of its extraction and production caps is precisely to restrict domestic consumption. We find it difficult to reconcile China’s claims that, on the one hand, it sets its extraction and production quotas *below* expected domestic demand, but that on the other hand, the export quota is necessary precisely to avoid a “domestic supply squeeze”. Without deciding at this point whether China has demonstrated that its measures do in fact restrict domestic production or consumption, we simply note that the stated goals of China’s export restriction (to prevent a domestic “supply squeeze”) and its extraction and production caps (to restrict domestic consumption) seem difficult to reconcile.

The Panel considers that not only foreign but also domestic consumers might seek to secure low-cost rare earth products. Indeed, China itself has recognized that there is also demand within China for illegally mined or produced products. As the Panel sees it, it is likely that there will always be some demand for illegally produced goods, which are often cheaper than goods produced by legal enterprises. But, as noted earlier, domestic demand for illegally produced rare earth products cannot be properly addressed through the imposition of an export quota. An export quota is not capable of responding to or tackling the conditions that incentivize illegal extraction and production in these cases because an export quota is simply a quantitative limit on the amount of (legally extracted and produced) rare earth products that can be exported. The amount that can be exported and the policing system that China needs to maintain in light of its conservation policy are two distinct considerations. China could maintain its reporting, checking, and policing mechanisms for rare earth products even if it did not limit the maximum amount of exports ...

The Panel is not convinced that China has demonstrated that its use of an export quota is an appropriate means of preventing illegal consumption *domestically* ...

In sum, there are a number of problems and inconsistencies in China's arguments that its export quota works to reduce domestic demand for illegally produced goods, and thus that they "relate to" conservation by enforcing China's extraction and production quotas. Considered together, these problems and inconsistencies cast doubt on China's claims that the export quota has a substantial, close, and real relationship with the conservation objective.

*(iii) Does the allocation of limited rare earth resources "relate to" conservation?*

Throughout this dispute, China has argued that the sovereignty it exercises over its own natural resources allows it to allocate rare earth products produced using Chinese rare earth ores between foreign and domestic consumers ... China explains that through its export quota, it manages what is effectively the world supply of rare earths. China adds that it does so in order to "ensur[e] an appropriate supply for foreign and domestic commercial users today".

China argues that its right to "manage the supply" of exhaustible natural resources is inherent to its sovereignty over exhaustible natural resources, which, in China's opinion, allows resource-endowed Members to "freely use and exploit their natural wealth and resources ... for their own progress and economic development". According to China, a finding by this Panel that China is not entitled to allocate the supply of rare earth products between foreign and domestic users would be anathema, since "it is simply not credible that resource-endowed countries would, by acceding to the WTO, have relinquished this fundamental norm" ...

The conservation objective embodied in Article XX(g) of the GATT 1994 allows Members to take their sustainable development needs into account in deciding whether to adopt a conservation policy, how to design that policy, and what instruments will be used to implement that policy ... In the context of Article XX(g), resource-endowed Members exercise their sovereignty over natural resources precisely by designing and implementing conservation policies based on their own assessment of various, sometimes competing, policy considerations, and in a way that responds to their own concerns and priorities ...

China maintains that its "supply management is not intended to protect or promote the domestic industry, but to ensure that the limited supply (specified in the production quota) is allocated in a manner that meets as much as possible the relative commercial needs of foreign and domestic users". China argues that it "undertakes this supply management given the particular

responsibility that comes with its role as currently supplying more than 90% of all rare earth supply”.

In the Panel’s opinion, once resources are extracted and have entered the market, it is neither China’s nor any other Member’s “responsibility” or right to allocate the available stock between different users; once extracted and in commerce, rare earths trade is subject to WTO law.

Therefore, *a priori*, trade in natural resources should not be restricted without justification. The Panel fails to see how, in this case at least, China’s allocation of quantities between foreign and domestic users can be justified as enhancing conservation.

At any rate, while it may be considered generous of China to want to protect the “relative commercial needs of foreign and domestic users”, the Panel believes that *a priori* determinations of what volume of rare earth products foreigners need or are entitled to are not directly linked to conservation. While the Panel acknowledges that there is nothing objectionable about Members accounting for their own and other countries’ development needs when adopting, designing, and implementing a conservation policy, the Panel does not believe that export quotas that delimit a maximum amount of products available for export from the already limited rare earth product supply are “closely” or “substantially” related to conservation ...

(b) Is China’s policy “made effective in conjunction with restrictions on domestic production or consumption”?

The Panel then turned to the second part of Article XX(g). This part of the text is sometimes called the *even-handedness requirement* because it requires that domestic producers or consumers also face environmental restrictions. The Panel began by discussing this legal provision.

The Panel now turns to examine whether China’s export quota on rare earths is “made effective in conjunction with restrictions on domestic production or consumption”.

China submits that its 2012 comprehensive conservation policy includes both *export* and *domestic* restrictions ... China argues that it meets the even-handedness requirement in Article XX(g) so long as it ensures that the impact of its conservation policy is imposed on domestic as well as foreign users ...

According to the complainants, the export quota, together with the production restrictions, ensures favourable access to domestic consumers at the expense of foreign consumers, fundamentally contradicting the “even-handedness” requirement.

The Panel now proceeds to determine whether (i) China imposes “restrictions on domestic production or consumption” of rare earths; and (ii) China’s export quota is “made effective in conjunction with” such restrictions on domestic production or consumption.

*(i) Did China restrict domestic production or consumption?*

To answer this question, the Panel considered each of the four components of China’s conservation policy: access conditions, volume restrictions, resource taxes, and environmental requirements. We focus here on presenting China’s argument and the Panel’s conclusion for each component. We omit the extensive discussions of how these various components worked.

[Access conditions:] According to China, enterprises wishing to mine rare earths in China are required to obtain a mining licence. Mining companies and smelting and separating enterprises must comply with certain access conditions before they can engage in and have access to the rare earth industry. These access conditions set a minimum production scale for mining, smelting, and separating, and impose a minimum recovery rate for mines and separating enterprises. China explains that these requirements are designed to eliminate small, inefficient producers ...

The Panel has difficulty seeing how these “access conditions” work to restrict the domestic production of rare earths. Although the Panel accepts that these access conditions make it harder for new enterprises to enter the rare earths industry, they do not control the amount of rare earths that enterprises already in the industry may extract or produce.

[Volume restrictions:] China argues that its 2012 comprehensive conservation policy for rare earths includes volume restrictions on domestic production in the form of quotas on the volume of rare earths that can be extracted and smelted and separated. China also posits that the combined effect of its export and production quotas for rare earths is to impose a volume restriction on domestic Chinese consumption of rare earth products.

First, the Panel recalls its conclusion, explained above, that it rejects the notion that measures are capable of restricting domestic production or consumption of rare earths solely on the basis of the

existence in law of a volume cap on extraction, production, or consumption of rare earths. In our view, China must also demonstrate that it has measures to effectively enforce these caps ...

China has not provided sufficient explanation as to why its domestic measure should be considered restrictive ... Without such detailed evidence, the Panel cannot conclude that the domestic quotas were set at levels below domestic demand. As such, in the Panel's opinion China has not demonstrated that it imposed volume restrictions on domestic consumption of rare earths in 2012.

[Resource taxes:] According to China, the resource tax seeks to conserve Chinese rare earth resources by reducing consumption; and the effect of a resource tax is filtered through the entire rare earth supply chain. Higher mining costs increase the costs of inputs for smelting and separating enterprises. The higher costs of smelted and separated rare earth products increase the costs of inputs for producers of downstream rare earth-using products, such as magnets and phosphors. The parties disagree on the effects that the resource tax could have on rare earth production in China. In particular, the complainants submit that a tax can have a restricting effect only if it is sufficiently high ...

The Panel acknowledges that increased costs caused by the tax could, in the long run, lead to a reduction in demand and therefore limit production of rare earth ores. Thus, resources taxes could work to reduce extraction of rare earths. However, in the Panel's opinion, China has not adduced sufficient evidence to persuade the Panel that the tax at issue here would be capable of having a limiting effect ... China has failed to convince the Panel that its resource tax imposes a real and actual restriction on domestic production.

[Environmental requirements:] China lists a series of measures imposing environmental protection requirements in support of its defence under Article XX(g) ... China explains that rare earth enterprises in China face significant costs in complying with the listed environmental requirements. According to China, these higher costs restrict production, first by eliminating a number of small and inefficient producers, and second, by causing a price pass-through effect from producers to consumers ...

The Panel has difficulty understanding how measures that promote the efficiency of resource extraction and production necessarily work as restrictions on domestic production as such. While

such measures might increase efficiency, they do not on their own impose any restrictions on the volume or pace of rare earth extraction or production.

*(ii) Were China's export quotas "made effective in conjunction with" domestic restrictions?*

The Panel then asked whether the export quotas were "made effective in conjunction with" domestic restrictions. The Panel focused here on the timing of various Chinese actions, including both when various quotas were set by the Chinese government, and when China added new elements to its conservation program.

The Panel recalls that subparagraph (g) requires that trade-restrictive measures work in conjunction with domestic restrictions to conserve exhaustible natural resources. The Panel considers that the "made effective in conjunction with" clause requires the simultaneous or perhaps near-simultaneous operation of the relevant foreign and domestic restrictions ... In the Panel's view, the phrase "work in conjunction with" also suggests operative complementarity between the foreign and domestic restrictions.

As the Panel has noted, China argues that its restrictions on domestic production and consumption of rare earths are *substantial*, and that domestic users, together with foreign consumers of rare earths, *collectively* bear the burden of China's conservation policy. For China, its export quota and its domestic restrictions work together in support of its comprehensive conservation programme ...

The Panel is not persuaded by China's argument. In our view, China has not explained how the export quota operates and works together with restrictions on domestic production or consumption for the conservation of rare earths. On the contrary, the Panel considers that China's export quota and the restrictions on domestic users or producers of rare earth referred to by China do not seem to work coherently towards the goal of conservation ...

[Timing of various quotas:] The Panel observes first that the three categories of quotas (export, extraction, and production) were set batch by batch at different times ... The Panel fails to see any coordination among the three categories of quotas that would suggest they work together, be it for conservation of rare earths or for other reasons ...

Indeed, in the Panel's opinion, the uncertainty and unpredictability caused by determining the level of the export quota only late in the year do not help rare earth users to rationally utilize the

available amount of rare earths. The insecurity about undetermined limitations may lead to stockpiling, smuggling, second-best alternatives, and sub-optimal investments by consumers ...

The Panel believes that China has not explained how the timing of its export quota ensures that the quota works in conjunction with domestic restrictions for conservation. The main effect seems to be to cause market instability with no clear conservation justification or connection.

[Temporal disconnect between export quotas and other elements:] Finally, the Panel finds it significant that China has imposed quotas on the export of rare earth products since at least 2002, but has, according to its own arguments, only maintained restrictions on domestic extraction since 2006 and on domestic production since 2007. The Panel recalls that China has argued that one of the goals and purposes of its export quota on rare earths is to enforce its domestic production and consumption quotas. In the Panel's opinion, however, this argument is difficult to reconcile with the fact that, for the years between 2002 and 2007, China did not impose any domestic restrictions. This raises doubts in the Panel's mind about the nature and, indeed, the existence of any coordination and interaction between the export quota and any domestic restrictions between at least 2002 and 2006. The Panel is well aware that the complainants chose to challenge only the 2012 export quota. Having said this, the WTO case law is clear that panels are entitled to look at the functioning of any challenged measure before and after the date of the request for establishment of a panel when this is useful for the Panel to understand the functioning of the challenged measure ...

The fact that China's export restrictions pre-date its extraction and production restrictions by 4 and 5 years respectively raises doubts as to whether these two sets of restrictions are designed to work together for conservation. These doubts are amplified when it is recalled that, as the Panel has already explained in the context of its discussion of the legal test under Article XX(g), the requirement that foreign and domestic restrictions "work together" generally implies some degree of temporal simultaneity.

In the Panel's view, the temporal disconnect between China's export restrictions and its restrictions on domestic production and/or consumption does not demonstrate, by itself, that the two sets of restrictions do not in fact "work together" for conservation. However, this temporal disconnection casts doubt on whether the measures were "made effective in conjunction" with one another. When viewed in the context of and together with the Panel's other findings above, the temporal disconnect between China's export quota and its extraction and production

restrictions simply reinforces the Panel's conclusion that the former do not seem to have been "made effective in conjunction with" the latter ...

(c) Conclusion on Article XX(g)

The Panel then concluded Part II by arguing the China's policy does not conform to Article XX(g).

In the Panel's opinion, it is difficult to conclude that China's export quota relates to the conservation of rare earths. The Panel is not persuaded that China's domestic consumption is restricted by the combined effect of China's production quota and export quotas. The Panel agrees that China has some restrictions on domestic production in place, but by setting the levels of the export quota significantly below the level of its alleged production cap, as China acknowledged it has done, China has effectively set aside specific quantities of rare earth products for domestic consumption. Rather than "relating to the conservation of exhaustible natural resources", then, China's export quota on rare earths seems designed to reserve amounts of rare earth products for domestic consumption.

In the Panel's view, nothing under the Chinese system actually acts so as to prevent expansion of Chinese domestic consumption at the expense of foreign consumption. China essentially leaves it to market forces to determine whether quantities permitted for exportation will indeed be exported and will not instead be used by domestic downstream producers. The Panel does not accept China's justification that its export quota enforces its domestic extraction and production quotas – and thus relates to conservation of rare earths – when there is no mechanism in place for tracing such rare earths that are initially destined for exports but which are finally consumed domestically. More fundamentally, the Panel fails to understand the usefulness of an export quota that is applied on less than 20% of rare earths extracted annually in China, to regulate the remaining 80% that is consumed domestically.

Importantly, the Panel does not agree with China that its sovereign right over its natural resources allows it to control international markets and the domestic and international allocation and distribution of rare earths. China, as a sovereign WTO Member, can control the amount of rare earths it extracts, but once such resources enter the market, they are subject to WTO rules, which prohibit quotas unless justified under one or more of the GATT exceptions. China has not convinced the Panel that the right in Article XX(g) to adopt measures for conservation provides

China with the right to control the domestic and international allocation and distribution of rare earths.

The Panel recognizes that it is vitally important for China to control at its border, via checking and policing exercises, all exports of natural resources, including rare earths. But the Panel fails to understand why such regulatory control is exercised through a quota system that limits the *amount* of legally produced rare earth products that can be exported. As the Panel has explained, there is no reason why China's legitimate customs controls and checks could not be carried out in the absence of an export quota. China could easily maintain the same legislative apparatus for policing exports even if it were not applying any export quota. Border controls and policing can be WTO-consistent even when imposed on products traded without quantitative restrictions.

Moreover, the Panel fails to see how an export quota administered at the border could in any way work to control or prevent smuggling that occurs outside of the regulated chain of commerce. As such, the Panel cannot accept China's argument that the export quota relates to conservation by assisting China to detect and prevent smuggling or illegal extraction and production, since, *inter alia*, the vast majority of what is extracted and produced is destined to China's domestic market.

The Panel notes also that China characterized its production quota, access regulations, resource tax, and environmental regulations as even-handed domestic counterparts to the challenged export quota.

In the first place, the Panel recalls that it has been unable, on the basis of the evidence presented, to find that China's extraction and production caps constitute "restrictions" within the meaning of Article XX(g). China has not provided the Panel with sufficient evidence of expected demand for rare earths during 2012, and as such the Panel cannot determine whether China's extraction and production cap were set at levels lower than the expected demand for the period of time over which the restriction was intended to apply (here, 2012).

The Panel recalls further that China's access regulations, production quota, environmental regulations, and resource tax affect domestic and foreign users equally, whereas China's export quota applies exclusively to foreign users. Since China does not impose any limits on domestic consumption or a tax that applies exclusively to domestic users, the Panel does not accept that China's export quota has any domestic counterpart. In consequence, the Panel finds that given the

structure, design, and architecture of China’s export quota system, it is not balanced or “even-handed”.

In the Panel’s view, China’s export quota seems to be designed to guarantee a minimum amount of rare earths for its domestic downstream industries, which are themselves encouraged to export their final products. This is also confirmed by the existence of stimuli for exportation of higher value-added products. The Panel notes in particular that, in contrast to its export restrictions on lower value-added products, China provides export incentives [to] higher value-added products that use rare earths such as rare earth magnets.

Having examined the design, structure, and architecture of China’s export quota and the related domestic restrictions, ... the Panel finds that China has failed to justify its rare earths export quota, which is the measure challenged by the complainants, under Article XX(g) of the GATT ...

Nonetheless the Panel continues its examination of the matter at issue with the parties’ arguments relating to China’s statement that its export quota complies with the chapeau of Article XX.

### Part III: Does China’s Policy Conform to the Chapeau for Article XX?

Next, the Panel asked whether China’s policy was consistent with the *chapeau*—or introductory text—for Article XX. It broke its analysis into three steps.

(a) Is China’s policy “arbitrary or unjustifiable discrimination ... or a disguised restriction on international trade”?

The first step for this part of the Panel’s analysis was to determine whether China’s policy was an “arbitrary or unjustifiable discrimination ... or a disguised restriction on international trade.” China’s main defense against this claim was that its export quotas from 2011 and 2012 were unfilled, meaning that foreign consumers bought less rare earth minerals than China would have allowed.<sup>2</sup> The Panel found this argument unconvincing because China had been using export quotas for over a decade, likely creating distortion in investment decisions about where firms should produce their goods.

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<sup>2</sup> China also defended itself by comparing the domestic and foreign prices of rare earth minerals. We set this argument aside because it involved complex economic calculations that were challenged by the complainants.

The Panel recalls that it is for China, as the party who invoked Article XX of the GATT ..., to demonstrate that its rare earths export quota is not applied in a manner that constitutes unjustified or arbitrary discrimination, either among foreign users or between domestic and foreign producers and consumers ...

China argues that the unfilled 2011 and 2012 export quotas demonstrate that there was no discriminatory treatment of foreign consumers as a consequence of the 2012 export quota.

The Panel agrees with China that, in general, quota utilization can be a relevant factor in establishing the existence and nature of a quota's restrictive effects. However, for a number of reasons, the Panel is not persuaded that such evidence is sufficient to establish non-discrimination here.

First, the Panel is not persuaded that the unfilled export quota is evidence of non-discrimination in this case because China has applied export restrictions (quota and duties) on rare earths for over a decade, and therefore the international rare earths market has adjusted to long-term distortions. China has not successfully rebutted the complainants' arguments that business uncertainty caused by the long-term imposition of export quotas could lead to reduced foreign demand of the product under quota, which could explain, at least in part, why the 2012 quota was not filled. Business uncertainty may lead foreign enterprises to opt for second- or third-best business choices, including relocation of downstream users to China to ensure a stable supply of rare earth inputs, thus representing a disproportionate cost for foreign enterprises even when the quota remains unfilled ...

As China itself acknowledges, if foreign demand shifts inward, the export quota can cease to be "binding", that is, it can remain unfilled, but this is not necessarily an indication that the export quota does not have any discriminatory effect on foreign users. Rather, this could be an indication that the export restriction, which China has applied for over a decade, has distorted international trade and investment. In other words, the effects of the export quota are not being compared to the appropriate counterfactual (China's exports had the quota not been in place) ...

It is difficult to determine in the case before us precisely the degree to which the lack of quota fill is attributable to, on the one hand, the international financial crisis and, on the other hand, the quota's long-term market distorting effects; at any rate, the important point is that China has not

convinced the Panel that its 2012 export quota did not have distorting effects that discouraged and reduced export trade of rare earths. The Panel is of the view that, under these circumstances, the evidence that the export quota was not fully utilized in 2012 does not demonstrate that China's quota has been applied in a non-discriminatory manner.

Second, the Panel is not persuaded that the unfilled export quota is evidence of non-discrimination because this argument ignores the fact that, as acknowledged by all parties including China, a large proportion of demand for exports of rare earths is satisfied illegally, i.e. through smuggling. While the Panel agrees with China that smugglers seek "to get past governments regulations" (including China's production restrictions), the Panel considers that, according to the evidence put forward by the parties, smuggling may also be due to the export quotas (beyond production restrictions) themselves. To the extent that an unfilled quota may be a consequence of the quota itself, i.e. because the quota's existence encourages smuggling that satisfies some foreign demand, the Panel considers that the unfilled quota in this case cannot be taken as evidence of non-discrimination.

The Panel is also concerned about the uneven and unbalanced structure of China's export quota measures. As the complainants have noted throughout this dispute, the measures that China alleges constitute "restrictions on domestic production on consumption," and especially China's extraction and production quotas and its taxes on extraction, also restrict foreign consumption of Chinese raw materials. In other words, every restriction on domestic consumption of Chinese raw materials applies also to foreign consumption. In contrast, China's export quotas impact only on foreign users: there is no corresponding burden, such as a domestic consumption quota, imposed by China on Chinese consumers. Additionally, as the Panel noted above, the difference in the scope of China's production and export quotas seems to favour domestic users while restricting foreign access to certain rare earths products, such as metals ... The Panel believes that these features of the 2012 export quota system, which impose unique and special burdens on foreign consumers, are discriminatory in its application.

(b) Is the rationale for the discrimination or disguised restriction justified (because it is concerned with conservation)?

This Panel then proceeded to its second step. Namely, it asked whether the reason for the discrimination or disguised restriction was conservation. It reviewed several problematic aspects of the Chinese policy

and concluded that China's policy seemed aimed at protecting domestic consumption, rather than conservation.

The Panel now proceeds to determine whether the discrimination that results from the application of China's rare earths export quota is nevertheless justified and rationally linked to conservation goals ...

The Panel recalls that more than 80% of rare earths extracted in China are consumed in China. In our opinion, it is difficult to understand the function of an export quota in a situation where the first threat to conservation is domestic. For the Panel, this suggests that the main effect of the export quota on rare earths is to guarantee that domestic consumption benefits from a minimum amount of the extracted rare earths.

In the Panel's view, although China maintains and enforces a comprehensive conservation policy, the manner in which it operates its rare earths export quota system seems to indicate that its export quota does not relate to conservation considerations but is aimed rather at controlling the amount of rare earths that leaves the country ...

In sum, China has not demonstrated that the market distortion or discrimination caused by the operation of its rare earth export quota is based on conservation considerations.

(c) Are there WTO-consistent alternatives that achieve the same objective?

This Panel then proceeded to its third step. The complainants argued that China could have achieved its goal of conservation without violating WTO rules if it had pursued alternative policies. These alternative policies included: limiting production; limiting domestic sales; increasing the enforcement of existing mining laws to prevent illegal mining; and creating and enforcing new domestic rules to prevent illegal smuggling. The Panel argued that these alternative policies seemed plausible, and that China had not adequately explained why they would not work.

China has not satisfied the Panel that it has fully explored and justifiably rejected the alternatives proposed by the complainants. In the Panel's opinion, China needed also to explain why such WTO-consistent or less trade-restrictive alternatives are not available to China. In the Panel's view, China has not done so ... The Panel considers that the alternatives proposed by the

complainants are reasonably available and appear to be capable of achieving China's desired level of conservation ... Therefore, for the Panel, the discrimination and trade distortion engendered by China's export quota measures were not based on conservation considerations and were both foreseeable and avoidable, including through the use of WTO-consistent alternative means ...

(d) Conclusion on the chapeau for Article XX

Based on the three preceding steps, the Panel concluded that China's policy did not satisfy the requirements in the *chapeau* for Article XX.

In view of the above, the Panel concludes that China has not demonstrated that its 2012 export quota on rare earths was not applied in a manner that constitutes arbitrary or unjustifiable discrimination or a disguised restriction on international trade.

Part IV: Conclusion

Overall, the WTO panel concluded that China's policy broke GATT rules on export quotas (contained in Article XI) and was not justified under Article XX. China had therefore violated the GATT.

For the reasons given above, the Panel concludes that China's export quota on rare earths is inconsistent with Article XI:1 of the GATT ... The Panel also concludes that China's export quota on rare earths is not justified under either subparagraph (g) or the chapeau of Article XX of the GATT.