

Testimony of Franklin J. Vargo
Vice President for International Economic Affairs
National Association of Manufacturers
On Behalf of
The National Association of Manufacturers
Before the
Senate Committee on Commerce, Science and Transportation
Subcommittee on Trade, Tourism, and Economic Development
Hearing on
“Piracy and Counterfeiting in China”
Wednesday, March 8, 2006

Mr. Chairman and Members of the Subcommittee,

I am pleased to have the opportunity to testify on behalf of the National Association of Manufacturers (NAM) this afternoon on “Piracy and Counterfeiting in China.” We applaud the committee’s initiative in holding the hearing. The damaging impact of this illegal activity on U.S. industry and the general public is serious and growing. And if we don’t get this problem under control, we are going to face severe consequences for our businesses, workers and the health and safety of our citizens.

The NAM is the nation’s largest industrial trade association, representing small and large manufacturers in every industrial sector and in all 50 states. Protection of intellectual property rights has never been more important for U.S. manufacturers than it is today. Our companies and workers--whether in Detroit, Los Angeles, Atlanta or Houston--are competing in a global economy against rivals not only in well established industrial countries but also, increasingly, in emerging economies such as China, India, Korea, Taiwan and Malaysia. These emerging economies, particularly China, are rapidly expanding their industrial base on an extraordinarily large scale, taking advantage of low labor costs, a less burdensome regulatory environment, lower taxes and, in some cases, deliberate currency undervaluation.

America's ability to create and use intellectual property such as patents, copyrights and trademarks provides U.S. companies with a critical competitive advantage that helps to offset lower labor costs and other advantages that these emerging economies have. Consumers also benefit. The protection of trademarks and copyrights ensures that consumers of U.S. products, whether these products are lifesaving medicines, critical safety components in automobiles or software used to manage complex industrial processes, have authentic products that will perform with the high standards and quality assurances of the U.S. producer.

In light of importance of intellectual property rights (IPR) for manufacturers, the NAM has devoted considerable attention and resources to addressing their concerns. The NAM is co-chairing the Washington-based business Coalition Against Counterfeiting and Piracy (CACP) that is seeking to raise awareness of international trade in fake products and promote stronger efforts by government and business to address the problem. We have lobbied for stronger enforcement measures against counterfeiting in U.S. legislation and more resources to strengthen cooperation with foreign governments, including the Chinese government. And we are seeking to mobilize manufacturers to improve their own internal practices to prevent counterfeiting, for example, by strengthening their supply chain systems to prevent fake products from getting into the hands of suppliers and customers.

How big is the problem of global counterfeiting and piracy? It is already huge and, according to our members, is getting worse—and China appears to be the center of the biggest international counterfeiting and piracy rings. The estimate of counterfeit products most widely used by both industry and government is 5 to 7 percent of world trade or a volume of products valued at over \$500 billion annually.

Much attention has been given to the problem in China and other countries of the widespread pirating of copyrighted products, such as computer software, films and music. There is no question that this remains a serious problem, and despite the attention it has received, relatively little progress has been made. In China, for example, it is estimated that less than 10 percent of films and software sold on the market are authentic products.

The counterfeiting of manufactured products, however, is also serious and affects a broad spectrum of U.S. industries: medicines, auto parts, components for industrial equipment, personal care products, chemicals, sophisticated computer routers and aircraft parts. Counterfeit products, of course, result in financial losses to U.S. companies when they are sold in place of legitimate products. But they also are a very real threat to consumers. Examples of defective products include:

- Medicines that contain life-threatening ingredients or grossly inaccurate dosages
- Batteries that explode because of faulty manufacturing
- Brake pads containing sawdust

- Engine timing belts that break after only 1/5 the time of the authentic product
- Razor blades that don't shave despite the quality brand name
- Refrigeration testing equipment that wouldn't test properly
- Faulty consumer electrical products that had false testing marks of a well known U.S. testing firm
- U.S. brand name golf clubs that could break because of poor quality production

The volume of the counterfeiting and piracy in China, according to reports we receive, appears to be growing. But so also is the sophistication of those engaged in illegal production. The packaging of counterfeit products has improved so much that even U.S. company marketing experts have difficulty telling the authentic product from the counterfeit one. Some pharmaceutical companies have told us that the only way they can determine whether a suspected counterfeit product is real or fake is by sending the item for testing at a company laboratory.

How counterfeiters manufacture fake products to avoid detection has also become more sophisticated. One U.S. consumer products manufacturer found that the counterfeiters were producing parts of the product in six different locations stretching over 80 miles. Final assembly was performed at different locations depending on the risk of detection.

Much of the counterfeit production in China is consumed in the local market. But a substantial quantity is also showing up in markets around the world—Russia, Saudi Arabia, the UAE, Mexico, Canada, Costa Rica, Colombia, Uruguay and, of course, the United States. In one case, Chinese and French police worked together to intercept 800,000 units of counterfeit consumer products that were transiting Paris from China en route to Uruguay.

Small companies face particular challenges in dealing with counterfeiters. One small NAM manufacturer that makes refrigeration testing equipment was not even aware that its products were being counterfeited in China until it started getting requests for warranty coverage in Saudi Arabia with products that had phony serial numbers but looked nearly identical to the company's products. An investigation revealed that the products came from China, but the company doesn't have the resources to pursue the case there.

To qualify for membership in the World Trade Organization (WTO), China had to bring its domestic IPR laws into conformity with standards established by the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). China's laws on defining intellectual property rights did in fact improve. But the enforcement of these rights still remains problematic.

On the positive side, the Chinese government has been receptive to discussing U.S. business concerns and taking some actions. The NAM appreciates the high priority that U.S. Trade Representative Portman and Commerce Secretary Gutierrez, and their predecessors, have given to engaging their Chinese counterparts on counterfeiting and piracy. Discussions on counterfeiting and piracy in the 2004 and 2005 U.S.-China Joint Commission on Commerce and Trade (JCCT) were substantive and resulted in specific commitments on issues important for U.S. business. Key outcomes included:

- China's pledge to significantly increase penalties and crackdown on violators
- Commitment to expand the range of IPR violations subject to criminal (as opposed to solely civil) penalties and increase the number of criminal prosecutions
- Agreement to increase enforcement action by Chinese customs to stop the import and export of counterfeit products.
- Assurance that Chinese government entities would only use legal software
- Commitment to rid Chinese trade fairs of counterfeit products

These are all important outcomes for U.S. manufacturers. Chinese follow-through on these commitments, however, has been uneven. Significantly, China did issue a judicial interpretation that permits, in theory, more criminal prosecutions. Some companies report aggressive enforcement actions by national and local authorities when detailed evidence of counterfeiting was presented. In a number of cases brought to our attention, police reportedly undertook extensive investigations in several locations that resulted in the arrest of many suspects (e.g., a dozen in one case) and the confiscation of hundreds of thousands of counterfeit items. The Chinese government claims that it has taken many enforcement actions that resulted in the closing of thousands of commercial establishments that sold counterfeit products.

In other positive developments, Starbucks announced earlier this year that it had won a trademark lawsuit against a Chinese coffee chain that was using its Chinese trademark. Luxury goods maker Louis Vuitton also scored a victory recently when a Chinese court reportedly sentenced two men to prison for exporting copies of its perfumes. And in November 2005, General Motors reported that it had reached a settlement with a Chinese auto company Chery that GM says acquired its compact car designs and was producing automobiles identical to the GM model.

Yet despite these positive anecdotes and Chinese claims of many enforcement actions, companies continue to tell us that counterfeiting and piracy in China is rampant, growing and on a very large scale. Enforcement actions, even when vigorously undertaken, appear to have little effect on the overall level of production and sale of counterfeit products. Moreover, we continue to receive reports of counterfeit products from China finding their way to countries around the world. The reports indicate that the Middle East is a major market for counterfeit products and transit point to third countries.

Manufacturers in other countries have also experienced similar problems with counterfeiting and piracy in China. Counterpart business organizations in Japan, Korea and Europe have told us that their members are seriously concerned about the large-scale counterfeiting and piracy of their products in China and the sale of these products in the domestic market and abroad. The Korean newspaper *Joong Ang Daily* reported on August 22, 2005, that two-thirds of electronics shops in Beijing, Shanghai and Guangzhou were selling fake Samsung products and that 30 percent of auto parts marked "Made in Korea" in eight Chinese cities were found to be fake. Counterfeit Korean consumer electronic products from China have been found in Peru, Israel and Egypt.

Chinese authorities continue to assert that the number of enforcement actions against counterfeiters is large and increasing. The authorities, however, have yet to provide detailed information on the penalties imposed on those involved in the production and sale of counterfeit products or the actions taken to close down factories and commercial outlets engaged in the illegal activity. We are particularly concerned that China has not substantiated its pledge to significantly increase the number of criminal prosecutions for counterfeiting and piracy.

China's failure to provide this information after repeated requests led the United States to seek help from the WTO. On October 26, 2005, the U.S. Trade Representative initiated a special process under Article 63.3 of the TRIPS Agreement to request that China release more detailed information about its IPR enforcement efforts. The NAM supported this action. We are disappointed that, thus far, China has not responded positively to the request.

In the next several weeks, the Administration will have important opportunities to seek further progress on improving China's performance on IPR enforcement. On April 11 the JCCT will meet again in Washington to review progress on the bilateral trade agenda, including IPR enforcement. The participation of Chinese Vice Premier Wu Yi and our two senior trade officials—Ambassador Portman and Secretary Gutierrez—will permit a high-level exchange on key policy concerns and a detailed review of past commitments, which in our view have not been fully implemented. Then later in April President Bush will be meeting with Chinese President Hu Jintao to discuss the overall bilateral relationship. We will be recommending that counterfeiting and improved IPR enforcement receive priority attention at both meetings.

Barring a significant improvement in China's performance on IPR enforcement, we see no alternative but for the United States to consider filing a complaint with the WTO and requesting that a dispute settlement panel determine whether China is living up to its TRIPS obligations. The apparent small number of criminal prosecutions, for example, suggests that China's IPR laws may not be adequate to ensure enforcement of companies' rights. Similarly, the unevenness in IPR enforcement among the different Chinese localities also seems to indicate that the national government has not effectively implemented the TRIPS agreement on China's behalf. The NAM is now exploring with member companies and organizations whether it would be possible to develop the kind of detailed information that would fully substantiate these claims in a WTO dispute settlement case.

The NAM, however, does not believe that business and government should leave resolution of the China counterfeiting and piracy problem solely to the WTO. Business needs to do a better job to raise awareness of the threat from international counterfeiting and the need to be pro-active to fight against it, for example, by improving company and industry practices on supply chain security. The NAM will be encouraging this through the CACP as well as its own member working groups.

U.S. agencies—particularly Commerce, State, USTR and Customs & Border Protection—need to continue strengthening their efforts to address counterfeiting and piracy in China and other countries. The STOP initiative has provided a good framework to do this. We are particularly pleased that more resources are now in place here in Washington and additional IPR experts are being assigned to U.S. embassies, including Beijing. We would urge even more attention to how improved customs procedures in the United States and our trading partners can be used to prevent the import and export of counterfeit products.

Finally, we hope that Congress will also continue to support efforts to stop international counterfeiting and piracy. First, we ask that Congress ensure the enactment without further delay of the Counterfeiting in Manufactured Goods Act (H.R. 32). At the time I was preparing this testimony, we learned that the House had scheduled a vote on March 7 to approve H.R. 32, as amended by the Senate. We appreciate the Senate's earlier action on the bill. The legislation is important because it will make it easier to prosecute individuals engaged in the production and sale of counterfeit marks that are intended for use on counterfeit products. We had been pressing other countries to adopt similar legislation to fight counterfeiting, and the United States would set a poor example if it haven't done so. U.S. anti-counterfeiting laws should be the gold standard, but we have a gap on counterfeit marks that must be fixed.

Looking ahead, Congress also needs to ensure that U.S. agencies have the resources to address a global problem that will have serious consequences not only for U.S. industry but the entire U.S. economy if it is not contained. The budget for the next few years will likely be tight. We shouldn't short change anti-counterfeiting efforts that are so important for U.S. economic interests.

Thank you for holding this hearing and giving the NAM the opportunity to present its views.