CHINESE BARRIERS TO TRADE: DOES CHINA PLAY FAIR?

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON RURAL ENTERPRISES, AGRICULTURE & TECHNOLOGY AND SUBCOMMITTEE ON TAX, FINANCE AND EXPORTS

OF THE

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THURSDAY, JULY 20, 2006

HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON RURAL ENTERPRISES, AGRICULTURE AND TECHNOLOGYJOINT HEARING WITH THE SUBCOMMITTEE ON TAX, FINANCE, AND EXPORTS
COMMITTEE ON SMALL BUSINESS
Washington, DC

The Subcommittee met, pursuant to call, at 10:00 a.m., in Room 2360 Rayburn House Office Building, Hon. Sam Graves [Chairman of the Subcommittee on Rural Enterprises, Agriculture and Technology] presiding.

Present from Subcommittee on Rural Enterprises, Agriculture and Technology: Representatives Graves, Barrow.

Present from Subcommittee on Tax, Finance, and Exports: Representatives Bradley, Chabot, Lipinski.

Chairman GRAVES. Good morning. I want to welcome everybody to the Joint Committee on Rural Enterprises, Agriculture and Technology Subcommittee and the Tax, Finance, and Exports Subcommittee joint hearing. It is my pleasure today to hold this hearing with Chairman Bradley as we explore the question of Chinese trade and fair policy when it comes to Chinese trade.

I also want to announce that Representative English is not going to be able to testify today due to another hearing that he has. Unfortunately, we have conflicts and they get in the way sometimes. But everything should go well. We have already seated our panel and we will just get started with that once we finish with opening statements.

Trade with China has grown faster than with any other U.S. trading partner. Currently, China is our third-largest trading partner, the second-largest source of U.S. imports, and the fifth-largest U.S. export market. The growth of the Chinese economy, in particular, their exports to the United States, has reached record levels and has created trade deficits of roughly $202 billion in 2005. Some of the reasons for these discrepancies are as follows.

First, since 1994, the Chinese government has kept its currency pegged at 8.2 yuan to the dollar. While in recent years, the dollar has weakened, the yuan has remained the same against our currency. Many economists estimate that the yuan is undervalued by as much as 40 percent, which means Chinese manufactured goods are 40 percent cheaper than their competitors.

Under intense pressure, China announced that it would appreciate the yuan to 8.11 yuan to the dollar, an increase of 2.1 percent, as well as pegging its currency to a basket of currencies rather than only the dollar on July 21, 2005. While I am not an economist or mathematician, if the yuan was 40 percent undervalued previously, then this slight adjustment still has the currency undervalued by 38 percent. I do appreciate that China has moved slightly by allowing its currency to increase by two percent, but much more needs to be done to level the playing field.

China has experienced economic growth, gains in productivity, a large export sector, and increased foreign investment. Their currency manipulation gives their manufacturers an advantage and creates an enormous disadvantage to ours.

Second, theft of intellectual property rights is another significant problem that U.S. companies must take into account when dealing with China. It is estimated that counterfeits constitute between 15 and 20 percent of all products made in China and account for about 8 percent of China's GDP. It is also estimated that US companies lose $25 billion annually to copyright violations.

I have heard it said that if you are a manufacturer and the Chinese are not copying your products, you are not running a successful business. While many people believe that this problem is restricted to purses or polo shirts, it is only the tip of the iceberg. Many people believe that it is a victimless crime; unfortunately, Chinese counterfeits or pirated items can impact our safety.

More and more often car parts, aircraft parts and even drugs are being copied. People buy what they believe are legitimate items only to find out later that their purchases were counterfeits. If this trend continues, more people will be harmed by fake medicines, faulty mechanical parts and even exploding batteries, whatever the case may be.

Worldwide, the market for counterfeit goods is growing and expanding. Global sales exceed $500 billion annually, although China is the biggest culprit. Over the last two decades the U.S. has pressed China to improve its protection of intellectual property rights. While China has passed new laws that provide protection of intellectual property rights, it has done little to enforce these laws, allowing for rampant piracy and counterfeiting. China needs to crack down and be an active part of the solution.

We need to ensure that U.S. firms compete on a level playing field in the global market and not be at a competitive disadvantage. These unfair barriers not only affect our economy but job growth, much of it fueled by small business, in this country.

I am pleased to recognize Representative Barrow for his opening statement.

[Chairman Graves' opening statement may be found in the appendix.]

Mr. BARROW. Thank you, Mr. Chairman. The focus of this hearing is to discuss the impact of Chinese trade policies on the U.S. economy, specifically the impact that trade has on our nation's small businesses.

I have asked a fellow Georgian to come join us today and talk about the cotton industry in Georgia and nationwide and how China's trade policies are affecting this industry. Mr. Will Coley is a

managing partner of Savannah Warehouse Services headquartered at the Port of Savannah.

I want to thank him for taking the trip up here and participating in this hearing.

Exporting goods has become more and more important to our nation's small businesses and farmers opening up new markets for our products and new opportunities for American industry. In the emerging global market base trade has become a common component for any successful small business plan. In today's global market it is that much more important that our small businesses compete on a level playing field.

Much of this country's success in the world market depends on small business and agriculture. Today 97 percent of exporters are small businesses and they make up over 50 percent of our nation's GDP. This includes many of our family farms. While access to overseas markets is important to our economy, we need to examine the impact that trade policy has on small business exporters in our country.

China is our third largest trading partner.

We are China's largest overseas market and China's exports represent 13 percent of U.S. imports. U.S. exports to China have been growing rapidly but competition from China is one of the biggest threats facing the small business sector of the American economy.

In the agriculture industry trade with China has produced mixed results. Historically the agricultural industry has maintained the largest of our nation's trade surpluses. Since 1998 that surplus has lost half its size with remaining export balance of only three billion and 450 million dollars.

As Chinese farm imports continues to surge in this country, increasing overall by almost 20 percent since last year alone, it will likely decrease exports sales for domestic agriculture business even more and harm the entire agricultural industry.

When it comes to setting currency regulations China isn't playing fair. This manipulation makes Chinese exports of the U.S. cheaper and U.S. exports to China more expensive. When it comes to honoring or depending our property rights China isn't playing fair.

Piracy and counterfeiting practices in China are costing U.S. farms billions of dollars in lost sales. This is of great concern to our nation's agricultural sector. Clearly China needs to start playing fair if we are going to avoid future damage to our agricultural sector and decrease agricultural imports.

Our trade policy seems to be one of letting small businesses have access to compete in the global marketplace but not giving them the means to succeed. We must give our small business entrepreneurs a fair chance at competing in these markets. It is important that we support this nation's entrepreneurs in all of their efforts to be successful. I believe members of this committee must not lose focus on how to guarantee the small businesses regardless of what country we trade with are competitive and have access to those markets.

It is clear that trade is and will continue to be an important aspect of the success of small business in this country. In the global marketplace we have got to stand up for American interest and also make sure that our small businesses remain competitive.

Standing by while small businesses, family farms, and American workers lose out is just not an option.

Mr. Chairman, I want to thank you for calling this hearing and look forward to the testimony of the witnesses.

Chairman GRAVES. Thank you, Representative Barrow.

Next we are going to hear from Chairman Bradley, Chairman of the Tax, Finance, and Export Subcommittee.

Chairman BRADLEY. Thank you very much, Chairman Graves. I will just submit my statement for the record so that we can more expeditiously get to the panel and I thank you for holding this hearing.

[Chairman Bradley's opening statement may be found in the appendix.]

Chairman GRAVES. Thank you, Mr. Chairman.

Mr. Lipinski.

Mr. LIPINSKI. Thank you, Mr. Chairman. As we previous members have talked about here, we face, and especially small businesses face, a terrible problem right now with our trade deficit, over $200 billion in trade deficit with China. I have many manufacturers, especially in my district, and other small businesses, but manufacturers are especially hurt because China simply does not play fair. That is all that we are asking for.

I think it is time for us to really stand up and do something about this. There has been a lot of talk about it. We all know that the Chinese currency is terribly undervalued. No real steps have been taken to move forward to do anything about this. Also, problems with intellectual property. We know China is not doing anything, or doing very little to protect intellectual property.

What this is doing is wiping out American small businesses. A lot of these are family-owned businesses. Continually in my district they come to me and tell me if nothing is done soon, we are losing these businesses. They are never coming back. It is not a situation where they are down now. We can wait a while and do something in the future and they will come back.

Once they are gone they are gone forever. They are not coming back. I have seen so many small businesses close in my district over the years and so many more are telling me they are doing everything they possibly can right now just to hang on but it is so difficult to compete against China. All they are asking for is a level playing field.

I am very happy that we are having this hearing today. I look forward to hearing from our witnesses here. I think it is time to do more than just talk. It is important that we continue to work to find the best way to level the playing field.

I know this hearing is not specifically supposed to be discussing it but I also believe we should be talking about H.R. 1498 which I think is a bill with real teeth in it telling China that if they do not make their currency really—let it float, or, at least, unpeg it so that it gets closer to what it should be valued at, the United States can't respond to that because it clearly is—to me China is clearly giving unfair advantage to their businesses by having their currency at that level. It is very clear to me. I want to hear from our witnesses today what their thoughts are on this and what they

believe we should be doing here in Congress to change the situation.

The only way this is just going to go away is when our small businesses who are working right now when they go away, when they disappear because we have not done anything to stand up to what China has done to unfairly manipulate the system. I am not saying we should be protectionists. I am just saying a fair level playing field. I look forward to hearing our witnesses today and what they recommend that we should do about this. Thank you.

Chairman GRAVES. Thank you, Mr. Lipinski.

All these statements made by the witnesses and the members will be placed in the record in their entirety. We will get started with our panel. I will introduce you as each come up.

First we are going to hear from one of my constituents, Tom Goodpasture, who is President of Pride Manufacturing Company in Liberty, Missouri. He is here representing the National Tooling and Machining Association. Tom has testified before this Committee before.

Welcome back. I appreciate you being here.

STATEMENT OF TOM GOODPASTURE, PRIDE MANUFACTURING COMPANY, INC.

Mr. GOODPASTURE. My name is Tom Goodpasture President, and owner of Pride Manufacturing Co., Inc. I started our machining job shop in Liberty, Missouri in 1997. Our company has grown to 28 employees and we service the machining needs for the following key industries: automotive, defense, railroad, medical, aircraft, computer and construction.

I appreciate the opportunity to discuss China's barriers to trade and its impact on manufacturing across the country and especially in Missouri.

I am an active member in the National Tooling & Machining Association and through this testimony hopefully I can voice the concerns of our company and our 1,600 member companies across the nation.

NTMA is one of the largest metalworking associations in America. It consists primarily of small-to-medium sized companies with average employment of 27.

The manufacturing sectors hardest hit by the China factor are the tool, die and mold industry, and the precision-machined parts industry. Every product that is manufactured is formed by a tool, die, or mold made by our industry. Precision machining and tooling industry is truly the backbone of manufacturing.

Our industry operates in a very competitive global marketplace. Many of the big name/large U.S. manufacturing firms have picked up and moved plants, or work to China with little regard for communities, employees and families. Vendor chains previously supplying tooling, components and assemblies to these plants while in the states have lost a tremendous amount of business.

I visited with Kim Hayden of Supreme Tool & Die in St. Louis a few weeks ago. Their company was so negatively affected by the amount of work going to China that their employment was forced from 65 to 32 almost overnight. Their sales revenue was cut in

half. By making huge adjustments they have survived and that is a success story.

One small die shop in Portage, Michigan lost 30 percent of its business due to the recent outsourcing by the Big Three automakers to China. The owner estimates that labor costs in China are one-tenth as much as those in the United States.

As component industries and design work follow assembly lines to China, key elements of the U.S. industrial base are beginning to erode. Nationwide, the National Tooling & Machining Association reports that 28 percent of the country's toolmakers have shut their doors since 1998. In the state of Missouri, we have gone from 239 shops down to 162 shops, that represents a 48 percent reduction of its tooling and component shops from 1998 to 2004.

As I talk to shop owners across the nation the plea is common, "Level the playing field. We are not afraid of competition, but make it fair competition." If U.S. manufacturing is to compete, we need to level the playing field. Manufacturing produces some of the highest paying jobs with the best benefits in the country. At Pride our "cost burden" over wages, with benefits, averages in excess of 35 percent.

A shopowner at a recent meeting who just received his company healthcare renewal and it was increased by 40 percent this year alone. We need the Small Business Health Plan legislation passed by Congress so we can negotiate association health plans to reduce costs. One employee's health issue should not rate an entire organization to the point that health care is unaffordable.

Currently it is almost impossible to compete with the low wages being paid in China. The only way we can keep our costs as low as China is by having automation that runs unattended and requires zero labor. That is how many of our businesses have survived. At Pride, we have invested in robotic equipment and Swiss Turn Lathes that run unattended "lights out."

Our machinists have now become technicians as well. I am proud to say that currently, we are producing component parts 24/7 for our local customer, which is being sold to China to be used in the Light Rail being constructed from Beijing to Shen Yang.

American manufacturers need the R&D Tax Credit. This critical tax credit, which expired at the end of 2005, needs to be reinstated retroactive so we can continue making investments in automation. This will offset high labor with zero labor so we can compete in the world market. After these investments into technology are made, we need the Estate Tax altered so that the next generation does not lose the business to taxation. These are things that could be done to level the playing field.

Last fall, I spent nine days in China on a NTMA Study Mission. I found that what we see and hear on the American news does not accurately reflect the China that I saw. Most of the manufacturing jobs are not the slave labor sweatshop jobs that I would have envisioned. Technology that I was hoping we could keep from China, is already there in abundance. The German, Swiss and Japanese influence in the plants is apparent and it is obvious that they were there long before us.

Although many of the laborers are young and less skilled that is rapidly changing. Firms from the U.S. and other countries, setting

up plants in China, send teams of engineers over to accelerate plant operation, in turn accelerating the Chinese manufacturing economy. I came away from that trip with two thoughts:

1. Whatever the United States decides to do or not do about manufacturing in China would make little or no difference to the Chinese.

2. The United States, because of our adversarial position, is missing a huge opportunity to sell to the commodity market in China while many other countries are selling to them.

China made a conscious decision several years ago to be a manufacturing community. They have been very successful in drawing large corporations from every major country in the world, to their low cost surplus labor society, while allowing them to escape the regulations that haunted them in their home countries.

Does China play fair? No. Factor in the alleged subsidization of the Chinese government, currency manipulation, no safety and environmental standards, and low wages, it is clearly not a level playing field. In many cases payment terms are different. Chinese companies require as much as 100 percent to be paid for prior to shipment from China. In contrast, the U.S. tool shops are forced to wait long periods of time to collect their money. Large businesses are forcing small businesses to carry their debt in this country.

Chinese manufacturers have no problem creating exact duplicates of components and equipment without regard for American intellectual property and patent laws. We have several area food equipment manufacturers that sell on the world market, whose products were reproduced and sold by China manufacturers. Even if the counterfeits are not sold in America, they have stolen these company's market share elsewhere that took years and large investments to create. Does China manipulate the currency? All evidence would say that it does. It is obvious that China's economic strategy over the past decade has been to keep the value of its currency low, boosting its exports and holding down imports. There is no free market for the yuan.

Companies relocating to China can benefit from the currency manipulation that is, in reality, a tremendous subsidy. When this subsidy is added to the very substantial differential in labor costs between our two nations, Chinese products become irresistible, and it makes investment in Chinese manufacturing extremely attractive.

I saw China prices adjusting according to what they can charge. A hotel room that should cost 12 cost 100 to 125. That is equivalent to almost a thousand dollars in the U.S. Many prices just do not follow the exchange rate. What to do about China is a complicated issue. China has made the wise choice to purchase their future in the world of manufacturing and thus far have been very successful. That is history. Now we are left with some hard truths.

We do not have enough mills to produce the raw stock to supply our own needs. Prices are going up in some cases at a rate of 30 to 40 percent for steel, stainless, aluminum, brass, and copper or more just because there is no supply there is no supply.

Although the actual numbers are being disputed, China is still graduating many more engineers than the U.S. We have an aging

and depleting manufacturing employee base that will reduce drastically over the next decade.

I urge our government to do what China has done. Make a conscious decision to keep a strong manufacturing base in America. We have lost ground. We must do everything that we can to regain our position and maintain it. In years to come without a strong manufacturing base our security and defense could be at risk.

China has not played fair; we cannot change the past. We must take hold of our future, and not allow our security and defense to be in the hands of China or anyone else. We must make American manufacturing strong and competitive. Thank you.

[Mr. Goodpasture's testimony may be found in the appendix.]

Chairman GRAVES. Next we are going to hear from George Russell who is the Corporate Legal Administrator for Auto Meter Products, Inc. He is here on behalf of the Special Equipment Market Association.

George, thanks for being here.

STATEMENT OF GEORGE E. RUSSELL, AUTO METER PRODUCTS, INC.

Mr. RUSSELL. Good morning, Mr. Chairman, and members of the Committee. My name is George Russell and I am appearing on behalf of Auto Meter Products, a member of the Specialty Equipment Market Association (SEMA). SEMA has 6,817 member companies, represents the $34 billion specialty automotive industry. This industry provides appearance, performance, comfort, convenience and technology products for passenger and recreational vehicles.

Auto Meter is a medium-sized company headquartered in Sycamore, Illinois that manufactures automotive measuring devices, gauges and tachometers, for the past 50 years, and for the high-performance automotive aftermarket.

In my prepared testimony I use Auto Meter has an example to illustrate what can happen to a medium-sized company when faced with the unscrupulous copying of American design and manufactured goods by Chinese competitors. I hasten to say that the experience of Auto Meter is illustrative of the wider problem faced by a variety of American manufacturers ranging from pharmaceuticals to aircraft parts.

Auto Meter manufacturers the highest quality performance automotive gauges in the world. Auto Meter's products are used in approximately 98 percent of all NASCAR racers, and a vast majority of performance racing cars on all tracks today. Approximately 10 to 12 years ago Auto Meter began to face competition from cheaply made imitations that copied its design and trademarks some coming from Taiwan and others from the People's Republic of China.

As indicated in my written statement, Auto Meter has used a variety of strategies to counter this threat including sourcing some of its components in the far east and exercising its legal remedies here at home.

Although Auto Meter has prevailed in its legal cases, the cost of victory has been significant. Over the last seven years the expense of Auto Meter defending and enforcing its intellectual property rights against counterfeit goods, primarily from China, has grown

from less than a 10th of 1 percent to over 4 percent of its gross annual revenues.

Auto Meter has spent well over $2 million in the last three years pursuing infringers and counterfeiters in the federal courts, the International Trade Commission and the Customs Service, and at trade shows in cooperation with SEMA and others. However, unscrupulous importers continue to source infringing and counterfeit products from China for sale in the United States. This has imposed on Auto Meter a significant burden and expense of continued efforts to find and stop new infringements.

Simply put, Chinese manufacturers have used all manner of duplicity to conceal their continued cloning of Auto Meter's products and enforcement is continually problematic and expensive for the victim.

Clearly, more needs to be done to protect legitimate U.S. manufacturers from this sort of mugging. Small and medium-sized businesses need the active and aggressive support of their government if they have any hope of competing, even on their home turf.

While Auto Meter welcomes the statements of commitment by the U.S. trade representative, the Department of Justice, and the Department of Commerce pledging to fight counterfeits, this is more rhetorical than real for companies such as Auto Meter.

Negotiations with the Chinese government have yielded commitments on their part to do something sometime. What is needed at the minimum is more active enforcement of laws already on the books to prevent this sort of conduct. In our view the Chinese would get a powerful message if the Customs Border Patrol inspections of the imports from China were significantly enhanced to detect illegal products before they entered the United States.

While I recognize that the first priority of Customs and Border Patrol is to protect the U.S. from terrorist activity, the cancer of imported counterfeits poses an equivalent threat to our economy and to thousands of jobs provided by companies like Auto Meter.

Stricter border enforcement against counterfeit and infringing products, of course, would not address the other matters you are considering today such as the disparity in the yuan evaluation but would signal that the United States is serious about protecting small businesses from the deprivations of counterfeiters and pirates.

I would be pleased to answer any questions you may have concerning Auto Meter's experience or that of other U.S. manufacturers in general who are facing these challenges.

[Mr. Russell's testimony may be found in the appendix.]

Chairman GRAVES. Thanks, George.

Next we are going to hear from Brian Duggan who is the Director of Trade and Commercial Policy with the Motor and Equipment Manufacturers Association here in Washington, D.C.

Brian, thanks for being here.

STATEMENT OF BRIAN DUGGAN, MOTOR & EQUIPMENT MANUFACTURERS ASSOCIATION

Mr. DUGGAN. Thank you very much, Mr. Chairman. My name is Brian Duggan and I am Director of Trade and Commercial Policy for Motor and Equipment Manufacturers. We represent 700 manu-

facturers of motor vehicle parts, components, technology, tools, and related products used in the repair and maintenance and original production of all classes of motor vehicles and heavy trucks. These manufacturers are known collectively by the term "automotive suppliers" and that is a term that I will use in my testimony.

What I think has already been made pretty clear here in the previous testimony is that the damage done by Chinese product counterfeiting is disproportionately serious for small businesses because they can least afford the lost sales on a limited number of brands and product lines and have fewer, if any, resources to protect their trademarks and patents, especially outside the United States in China or in third markets. Many of business' financial problems caused by Chinese counterfeiting and patent infringement in the autoparts industry are occurring across the board, small, medium, and large.

I plan to cover just in the testimony briefly some of the dangers posed by trafficking in counterfeit autoparts including consumer safety hazards, loss of brand image, and loss of export markets for American suppliers. Lastly, I would like to provide just a few of our views on work underway through the STOP program, which is Strategy Targeting Organized Piracy, that you may be familiar with, and other Federal efforts to help industry.

Product counterfeiting and other willful intellectual property theft is not a trade problem or a competitiveness problem in the usual sense. Product counterfeiting and IP theft is first and foremost a global crime. American automotive suppliers are now, on top of everything else, competing with global criminal networks out to steal from legitimate producers that play by the rules and work to provide value and service to their customers in the United States and abroad.

To the extent the People's Republic of China is now used as a hub by criminals for production and trafficking of counterfeit automotive parts and components, it is essentially offloading the cost of law enforcement and public safety to American industry and the U.S. Government.

Automotive suppliers have been targeted by Chinese-made counterfeit products for several years. Just as Chinese manufacturers have become more competent in the manufacture of legitimate goods over the past several years, they have also become more competent and aggressive in manufacture of counterfeit goods.

Patent infringement and product counterfeiting, which has already been explained here, are the primary forms of intellectual property violations against all American automotive suppliers.

I have brought here just a few samples. I won't go through them because there isn't time but later on if you or your staff would like to inspect any of these, you will see two things. First of all, you will see how similar the counterfeit and the real look. Visual inspection you cannot tell. Even the manufacturer has to go back and check the metallurgy and the fittings and things like this.

But when you cut this stuff open, then it is pretty clear which one is counterfeit and which one isn't. Unfortunately for a lot of these products, whether the consumer buys them or whether you are a garage mechanic buying them or whoever, you buy by the brand, you buy by the box, you buy by the SKU number.

A little bit on the measurement of the problem which I know is on your mind. Private companies and industries are well suited to measure sales, cost of production, and profits. We are not, however, well suited to measure global crime and, therefore, unfortunately no authoritative estimates of the production and sales of counterfeit automotive parts and components in China, the United States and around the world.

The OECD is in the process of doing a study on this. The study is due out in the fall. We provided information for the study. I am sure several others did, too, and we will see what that produces. Nevertheless, the industry does indicate the parts most often counterfeited are for the repair and replacement market.

They tend to be products that can sell quickly in high volumes. Examples of such parts would include spark plugs, shock absorbers, oil filters, fuel filters, fuel pumps, break components including pads and linings, suspension and steering components, windshields, tires, headlights, taillights, engine mounts, and other engine parts.

There are some astonishing and disturbing examples of product counterfeiting in our industry, including the following:

Federal agents in Queens and Manhattan seized $700,000 worth of unsafe, counterfeit brake parts, taillights and other parts that were being installed by dealers on city taxicab fleets. The danger of installing critical safety parts on city taxicabs in New York is enormous.

An investigation by one American automotive supplier found a company in China switching signs in front of their factory, making customers believe they produced legitimate branded parts. The Chinese producer further misrepresented itself to customers by using phony stationery and signs in the factory and they could just change these.

As different customers came through they could change their identity. Investigators for the company staked this out and found this. This Chinese producer infringed on the trademarks of several American and European automotive brands. That is another thing to point out, the guys don't specialize. They will rip off anybody.

A Midwest automotive supplier reported lost sales from product counterfeiting of $40 million and additional legal costs of $5 million annually.

Counterfeit oil filters made in China found in the United States contained cardboard and foam instead of filter material and was illegally labeled "Made in the USA."

A Chinese-based website has been barred from participating in America's largest automotive aftermarket trade show for trafficking counterfeit automotive parts and components.

The inferior quality, durability and workmanship of counterfeit automotive parts leads to another very serious problem for legitimate producers and that is brand destruction. When a customer unwittingly purchases a counterfeit product, and the product fails to perform and provide value, the reputation of the brand is diminished.

What I mean by that is if you would buy this counterfeit sparkplug set and after a short period of time it stopped working, you are probably not going to go back and buy that same brand,

or your shop isn't. Measuring loss of customer good will, brand destruction caused by fake parts is very, very difficult.

The losses caused by brand destruction are as great, or even greater, to a company than the loss of sales caused directly by the original sale of the counterfeit auto parts. This is particularly acute for small businesses where their whole business may be built on four or five or six products and two brands. That is it. If one of those gets hurt, you have lost half the shop.

Product counterfeiting is destroying export markets for American automotive suppliers and genuine American brands. American manufacturers cannot export product or build their brands around the world if their products are already widely available in counterfeit form. This is a serious problem in China and many other developing markets.

Looking forward to the matter of managing the problem, I would say that the cost, time and complexity of defending intellectual property rights at home and abroad is a serious challenge for small and medium-sized automotive suppliers. Federal, State and international actions aimed at addressing this core problem of the cost will deliver the most value to small businesses and we believe deserve Congressional support.

Also, maintaining a focus on law enforcement and actions that do not depend entirely on near-term changes in China (which is highly uncertain at best) are also a priority. Just to be clear about it, elimination of the production and trafficking of counterfeit goods, auto parts and others, in China is an ultimate long-term goal. Absolutely no doubt about it. In the meantime, there are meaningful near-term action is necessary.

The Federal Government has taken some very useful actions to combat trafficking in counterfeit goods that help industry. For example, the Department of Justice has increased the number of prosecutors and the FBI has increased a number of intellectual property undercover operations. These actions make Federal assets more accessible to small businesses. "Victims Conferences" and legal seminars organized by the Justice Department and the Patent and Trademark Office provide specialized training and guidance to small businesses at no charge.

The Patent and Trademark Office in cooperation with the Department of State is deploying intellectual property attaches to trouble centers around the world, including China. These attaches will be a resource for small companies that cannot afford foreign staff. More programs of this kind deserve Congressional support.

There are other Federal actions that if done properly could provide a valuable service to small business and help them manage the high cost of protecting their brands. I would like to get into one particular area regarding trade shows. I am over so I will go quickly.

Many small and medium-sized automotive suppliers build their domestic and foreign sales by displaying at trade shows. Trade shows are a long-standing institution in the automotive industry domestically and abroad. Counterfeiters, unfortunately, also use trade shows to traffic in fake goods. According to our members, many foreign trade show organizers take little or no action to help

American companies who find counterfeits of their products on the show floor.

Organizers of prominent trade shows in the United States enforce rules against counterfeiting.

Over half of our members, MEMA and other private sector organizations including the Coalition Against Counterfeiting and Piracy, are urging the Foreign Commercial Service to conduct a targeted fact-finding aimed at raising standards of intellectual property protection at foreign trade shows. In our request for assistance we would as this fact-finding to be conducted using the agency's overseas staff and work with the private sector and the Patent and Trademark Office to determine standards of intellectual property protection and enforcement at many foreign trade shows in developing markets.

Current the FCS supports and endorses many trade shows abroad and has a long-standing relationship with show organizers. We believe that the Foreign Commercial Service can perform an important service by conducting this fact-finding requested by industry and leveraging its relationship with foreign show organizers to raise standards of intellectual property protection.

We would ask this Committee to review this problem with the Foreign Commercial Service and encourage them to work collaboratively with industry and rights holders on this problem.

In conclusion, the automotive supplier industry and MEMA would like to thank the Committee for turning its attention to this problem and I would be glad to answer any questions you might have. Thank you.

[Mr. Duggan's testimony may be found in the appendix.]

Chairman GRAVES. Thanks, Mr. Duggan.

Next we are going to hear from Dr. Tom Duesterberg who is President and CEO of the Manufacturers Alliance here in Washington. Thank you for being here.

STATEMENT OF DR. TOM DUESTERBERG, MANUFACTURERS ALLIANCE/MAPI

Dr. DUESTERBERG. Mr. Chairman, thank you for having me. It is a pleasure to be here on this panel today discussing this very timely subject.

The Manufacturers Alliance is a research and educational organization representing over 500 small to large companies. This subject is timely partly because China continues to be a major competitor of ours and we are estimating that this year China will surpass the United States as the world's leading manufacturing exporter.

I am going to focus a little bit on the aggregate or the macroeconomic questions that have been raised in the past and continue to be an issue with regard to trade with China. I am going to focus on some of the reasons why we are not exporting more to China. We generally are supporters of open markets but we have noticed that even though China is the fastest growing large economy in the world, China also is at this stage of development in huge need of capital goods. The United States manufacturing sector is the leading producer of capital goods in the world. Our exports simply should be growing much more vigorously than they have been.

Some of the reasons that our exports are not growing more rapidly, first, is the anomalous rate of private consumption in China relative to investment and government spending. China has an unprecedented low level of consumer spending that has never been seen in the world, at least in the modern world.

Only 47 percent of the Chinese economy is represented by the household sector and that compares with 70 percent in the United States. The Chinese level is about 20 percent lower than it is in India, Poland, and Brazil, pure countries that it can be compared to. Part of the reason for that is the undervalued currency which I will turn to in a minute.

Second, the United States is actually losing market share in Asia to China and to other producers in Asia. Again, this is partly due to undervalued currency. I provide some figures in my testimony showing that our market share in the eight leading economies of Asia has declined from 38 percent in 2000 to 26 percent in 2005. We have lost market share in places like Japan where exports have actually declined this decade partly because China has taken market share from us there as well.

The Chinese are leading regional integration movement in East Asia trying to sign up a series of free trade agreements that exclude the United States. The regional identity of the Asians is part of the reason that we are losing market share there.

Third, I note that tariffs are still high. This is a mundane point but Chinese tariffs are much higher than U.S. tariffs and these need to be lowered.

Fourth, we have been making a case at the Manufacturers Alliance for years that the Chinese systematically undervalue their currencies. This, in turn, leads other Asian nations to undervalue their currencies to remain competitive with the Chinese.

Finally, and this is especially important to small businesses, there are a number of non-tariff barriers to trade in addition to the theft of intellectual property which has been eloquently expressed here already. I listed a few things that are worth looking at, the hidden cost of doing business. We call them hiring costs, firing costs, paying taxes, enforcing contracts, dealing with licenses.

All are much more difficult in China than here obviously. They are much more difficult for the small businesses who are trying to penetrate that market. That is partly why only eight percent of small businesses, small and medium enterprises, rely on exports for more than 25 percent of their revenues and that number is really not growing.

Some of the things that we think should be addressed in order to begin to rectify this situation, we think that the United States must energetically seek to participate in the growing Asian free trade movement. We have made a good start by opening free trade negotiations on a bilateral basis with South Korea, Thailand, and Malaysia but ultimately we need to be a part either through APEC or some other multi-lateral institution we need to be part of the Asian free trade area.

Second, the United States needs to be more aggressive in working with China to address some of these IPR questions and the fundamental question of the undervaluation of their currency. We believe there are mechanisms out there such as working with the

IMF and the World Trade Organization both of which prohibit systematic undervaluation and manipulation of currency for the benefit of a domestic economy such as China has been doing. We need to be much more aggressive in working with the Chinese, working with our own partners like the Europeans and the Japanese to address this problem.

Third, we continually shoot ourselves in the foot here in this country by imposing higher costs on U.S. suppliers than our competitors do. We call these "structural costs." We have estimated that we had 22 percent or more to the cost of producing a product here in the United States in comparison with our trading partners. We need to do things like look at the energy crisis, look at regulatory costs, look at taxes to try to bring down those costs.

Finally, as Brian mentioned, there are many things that the U.S. Government can do to help small and medium exporters especially through the commercial service at the Department of Commerce and through the Small Business Administration. We need to take a stronger look, I think, at working with the commercial services, especially in their programs to help small business.

I would be happy to answer any further questions.

[Dr. Duesterberg's testimony may be found in the appendix.]

Chairman GRAVES. Thank you, Mr. Duesterberg.

Mr. BARROW. Thank you, Mr. Chairman, for this opportunity to introduce my witness as the Ranking Member of the Subcommittee on Rural Enterprise, Agriculture and Technology, I wanted to take this opportunity to shine the light on the impact that China trade has on the agricultural sector of our economy.

There are very few people who are in as good a position to address that subject for us is my friend Mr. Will Coley from Savannah. He is here representing the National Cotton Council. He is a member of their current leadership class, the National Cotton Council's leadership class. He is in the cotton export business. He is going to shine the light on the problems we are having with China trade as it affects agriculture in this country.

Mr. Coley, thank you for being with us today.

STATEMENT OF JAMES W. "WILL" COLEY, NATIONAL COTTON COUNCIL

Mr. COLEY. Thank you, Mr. Chairman. I will do what I can. I would like to thank you again and all the members of the Subcommittee for inviting me to discuss trade with China. I especially want to thank Representative Barrow for his courtesy and his recognition of the significance of trade with China to the U.S. cotton industry.

As he said, my name is Will Coley. I own and operate a cotton port warehouse in Savannah, Georgia.

There are few international trade relationships more complicated or dynamic than that of U.S. cotton and China. The U.S. cotton industry is exporting an ever-increasing amount of cotton fiber to China. At the same time, our long-standing and best customer, the U.S. textile industry, continues to contract and face of competition from textile imports.

China is the most competitive textile and apparel manufacturer in the world. With the elimination of all quotas from January 1,

2006 and even with the imposition of special safeguards and a bilateral agreement covering trade in key textile products, China is rapidly becoming the dominant supplier of textile and apparel products in world trade.

In fact, China now accounts for almost 50 percent of all textile imports into the U.S. This development has ramifications for the U.S. textile industry as well as for virtually every other textile producing country, particularly less developed countries, or LDCs, in Central and South America and Africa.

A few statistics will illustrate the dynamic nature of the trading relationship between U.S. cotton industry and China. In 1998, China imposed a quota on cotton imports and imported only 359,000 bales of cotton from all those countries. In 2005 China imported a total of 19 million bales. At least nine million of those bales were supplied by the U.S. You can see the drastic difference there.

At the same time China exports of cotton textile products to the U.S. continues to increase dramatically while U.S. mill consumption of cotton declined from 11 million bales to about 5.5 million, a 50 percent reduction in cotton consumption by U.S. mills in just a 10-year period.

During the same period U.S. consumers have increased their purchases of cotton products at retail but almost 90 percent of all purchases are imports. With this astounding rate of increase in cotton production, cotton mill use and cotton imports China has rapidly become the dominant force in world cotton trade.

The reduction in domestic consumption has required the U.S. cotton producer to identify new export markets and none have been as challenged as south eastern producers who previously sold the bulk of their production domestically. In fact, my warehouse is located on the port of Savannah to better service the growing volume of exporters for producers in our area.

With that brief background, I can better address the subject of today's hearing. The answer is yes, China does maintain barriers to fair trade and engages in practices that provide unfair advantages to its manufacturers. The cotton industry is deeply concerned by the use of tax rebates to encourage exports.

We are troubled by the widespread use of subsidized or forgiven loans provided to China's domestic textile industry. We believe that the maintenance of an undervalued currency constitutes an unfair trade practice. As a small business operator I know it is impossible to compete with a firm that enjoys a 30 plus percent cost advantage due to undervalued currency and has access to free capital in the form of loans that never have to be repaid.

I know that U.S. textile farms are concerned about the piracy of their fiber designs and unauthorized use of their logos and brands similar to what these gentlemen have been discussing. They have spent millions of dollars developing all these brands and logos. If these unfair practices are allowed to continue much longer, U.S. manufacturers simply can't compete to provide jobs and continue to serve as an economic engine for our country.

While part of the cotton industry enjoys the benefits of a growing trade in raw cotton there are problems. We have consistently ex-

pressed concerns for the way China has implemented its market access commitments under the WTO accession agreement.

We have worked closely with the USDA and the USTR to attempt to convince China to modify its administrative tariff rate quotas, or TRQs, so mills producing for the domestic market have equal access to imported cotton as do those who produce for export markets.

Recently China has begun imposing a variable rate tariff on imports of cotton over the TRQ. This will increase the price of cotton to the mills compared to domestically produced synthetic fibers and effectively amounts to a price support program for Chinese cotton farmers.

By effectively reducing demand for cotton over synthetics affects all cotton farmers. We have also worked with the USDA, USTR, and the Chinese government and industry to resolve contractual issues, arbitration practices and quality standards.

Mr. Chairman, China is the dominant factor in the world of cotton and textile market and it is imperative that the U.S. cotton industry continue to cultivate China as a customer for our fiber. It is also critical that we work with Congress and the administration to insist that China honor her WTO commitments. We believe it is important that the China economy grows and merges into the world economy and that the U.S. manufacturing base does not become a casualty of that.

That is why we are actively supporting efforts to convince China to move to allow her currency to be valued by the market. We believe support for H.R. 3004 creates an incentive for China to allow her currency to be valued by the market, not by artificial means.

We also support the use of textile safeguards as authorized under the WTO accession agreement to allow the U.S. industry to adjust to the elimination of quotas. We urge the USTR to favorably respond to the proposal to conduct secretarial negotiations in textiles and apparel as part of the DOHA round to ensure that the textile and apparel industries in truly less developed countries are not totally displaced by the Chinese market.

We have heard criticism that the U.S. industry has had ample opportunity to adjust. As a business operator I contend that the adjustment can't be accomplished as long as Chinese manufacturers have the competitive advantages provided by an undervalued currency, tariff rebates, nonperforming loans, and unchecked piracy of valuable designs and labeling brands.

We welcome China to the WTO and we value her as a trading partner but she must be held accountable to the rules and commitments of the WTO membership.

Mr. Chairman, again, thank you for allowing me to testify. I will be pleased to respond to any questions at the appropriate time.

Chairman GRAVES. Thank you, Mr. Coley.

[Mr. Coley's testimony may be found in the appendix.]

Chairman GRAVES. We will start out with questions. Again, all the statements made by the witnesses will be placed in the record in their entirety.

The first one I have, I guess, is not really directed at anybody. Mr. Duggan, you might want to answer it to start off, or Mr. Russell, or Mr. Goodpasture. You mentioned the only way you can tell

a counterfeit from the real thing is if you cut it open but nobody is going to cut it open if they are buying something new.

If they are buying a gauge, they are not going to cut it open to see if it is the real thing or not. How is a consumer or how is a mechanic or somebody that is operating a store, how are they supposed to tell or how are they supposed to know what is counterfeit and what is not counterfeit?

Mr. DUGGAN. That is why we are so concerned about this because right now we don't really have a good way to tell. The individual consumer or the guy that runs an Auto Zone or an NAPA, obviously if he has a relationship with the supplier, that is built on some business trust there. The thing is, you know, the people who are trying to do this are criminals and so they are slipping it into the system, you know.

A lot of times the garage mechanics and the distributors are duped every bit as much up and down the line as anybody else. I mean, I guess the answer is no, we don't really have a system right now. There is some practical business advice which is deal with people who you know. That helps but that is not a full solution.

Chairman GRAVES. Go ahead.

Mr. RUSSELL. Mr. Chairman, to support what Mr. Duggan just said, I guess the best way to explain it from a manufacturer's perspective is Auto Meter has prided itself on having a warranty policy that is without reproach. We stand by the goods that we manufacture. That brand identity and that brand recognition is what is most appreciable by the consumer market.

The only thing that could reasonably be done, in my opinion, would be that we would have to determine some way in which brands and brand identify would be protected up front. That is why I made the statements regarding Customs and Border Patrol inspections of incoming goods. Beyond that point it is very hard for the average consumer, as you can see by Mr. Duggan's examples, and I could speak for quite a while, about goods that are essentially identical in appearance that are counterfeit and, thus, the consumer gets defrauded.

I guess if I could summarize to answer that question, there needs to be some kind of methodology developed that enhances or further enables Customs, Customs and Border Patrol, Immigration and Customs Enforcement, with the ability to discern when products are coming in that are not of that brand, whether that is intercepted at a port of entry or it is being reported by a manufacturing concern within the country once it has been discovered.

Chairman GRAVES. Another question. I don't remember if it was Mr. Duggan or Mr. Duesterberg mentioned the added cost of hiring and firing, regulatory licensing. I am assuming that is aside from the currency issues we have. Those are just issues that obviously are in the United States. You don't have to deal or you have a lot tougher time dealing with those in, say, a company in China.

Mr. Goodpasture, you actually mentioned, and I think you said, you have lights-off manufacturing going on. It runs all night long. I think I read in maybe your testimony that you have a shift that nobody is there but you continue to manufacture 24 hours. Is that in direct response to trying to compete?

Mr. GOODPASTURE. Oh, sure. If there is no labor, it doesn't matter if the machine is sitting here in China. We can produce it equally as well and probably better and for a competitive price. Labor is the cost so that is a direct response to dealing with China on our part so we can produce at the same price.

Chairman GRAVES. Coming back to Mr. Duesterberg, I would add litigation to that, too. You have litigation issues in the United States. You have regulatory issues and licensing issues. You have environmental issues. The list goes on and on and on that you have to deal with, regulatory in the United States that you don't have to deal with anywhere else.

Dr. DUESTERBERG. You have to deal a lot less in some other places. I highlighted in my testimony that the recent rise in the cost of natural gas, which is on average tripled in the United States over the last six or seven years, we are now the highest cost location in the world for natural gas. That is a feed stock that goes into chemicals. It goes into fertilizers and so on and so forth.

I think with regard to the first part of your question, the sort of hidden cost that occur in trying to do business in a place like China, a perfect example is with all this counterfeiting there are mechanisms available to try to pursue that in the Chinese courts but they are enormously opaque. They are enormously expensive.

Some of the data that the World Bank is now providing comparative data on how much it cost to do these sorts of things in various parts of the world, for instance, in terms of enforcing contracts in China it takes on average about one quarter of the total amount you're seeking to recover in terms of a debt if you are using the court system, whereas in the United States that number is much less.

That is a special burden on small businesses because the margins are typically thin in manufacturing to start with and it sometimes is just not worth the cost of doing business so that locks us out of the market itself.

Chairman GRAVES. Mr. Barrow.

Mr. BARROW. Thank you, Mr. Chairman.

Mr. Coley, I want to follow up on something you were talking about because I have a concern about what is going on with our cotton trade with China. The concern I have is that we are exporting so much more raw material to them but we are not really getting into their market because they are directing the raw material we are exporting to their country into their textile export market rather than their domestic textile market which will allow the cotton we grow here in this country to end up on the backs and in the homes of Chinese which will open up that huge potential marketplace to us.

They are steering our cotton into their textile export markets. Our raw materials are shipped from this country over to theirs, processed in that country and shipped back here for us to purchase so the only net thing we have achieved in this is the exporting of our manufacturing jobs, the processing jobs in the middle.

What is contributing to that? How are they doing that and what can we do to do and get them to open up their markets so we get market access out of this deal?

Mr. COLEY. Well, hopefully obviously their domestic consumption has to increase if our cotton goes as opposed to, like you say, sending them back here. I think hopefully with them entering into the WTO we might see some changes that way. The biggest thing is more domestic consumption and purchasing by the Chinese people of the cotton goods that are being produced there as opposed to just turning around and being shipped back.

Right now it has just been official for them to send a t-shirt back to Wal-Mart here in the States to resell it as opposed to actually having it there. That ends up making their huge domestic product the capital of their domestic cotton growers and denies us access to that market. They produce twice as much of the cotton they currently consume themselves.

In other words, for what they grow themselves in China they are actually consuming twice the amount they produce there locally. There is a market there certainly with the population. Certainly the idea that the clothing they are buying is not being marketed and U.S. cotton is not being directly marketed to those people and they are getting to use their own domestic consumption more or less.

Mr. BARROW. I hear you and I will tell you what I hear from other folks. Membership in the WTO has its opportunity and also has its responsibilities. Floating currency is one of the things that is part of the deal. We are not getting that.

Enforcement of our intellectual property rights in their economy is supposed to be part of the deal and we are not getting that. My concern in particular as it affects agriculture is we are exporting our own materials but we are not getting any excess of their market and that is something we are also supposed to be getting out of that deal. I have been hearing that a lot. Thank you very much.

Chairman GRAVES. Mr. Lipinski.

Mr. LIPINSKI. Thank you, Mr. Chairman. Mr. Goodpasture had said in this statement that China really made a decision to—I don't remember the exact words but potentially become a manufacturing country to really support manufacturing jobs, made a conscience decision to do that. I feel that China makes this decision. They put the policies in place.

We sit here and we say, "We are just going to have a free market." A free market means if someone else is exploiting it on the other end. Free market means jobs freely flowing out of out country because China is unfairly manipulating its currency and not enforcing intellectual property. They have something they are trying to do and they have been very good at doing it.

Now, one thing I wanted to ask Mr. Goodpasture to expand on a little bit is the impact on national defense. You had talked about tool die and mold industries are really being especially hurt. I have Atlas Tool and Die in my district and I am always hearing about the difficulties that they are having. When we lose these manufacturers what does that do to our ability to defend ourselves? How does that have an impact?

Mr. GOODPASTURE. I think right now we have a lot of defense equipment and storage that has been made. For example, in 1994 we were producing, I think, 840 tanks a year, M1A1 tanks. Right now we are not producing any. I work for General Dynamics. That

was for another company I previously worked for. I was at a meeting at General Dynamics about a year ago to just begin the process of doing work with Pride and I was told they could not get armor steel.

There are shortages of steel so, I mean, if we actually get into a situation that we need to produce tanks again, the Defense program has dropped. We have made a lot of things and we have dropped off production on a lot of items. If those situations would take off, No. 1, we don't have enough material. No. 2, we are losing our manufacturing base to produce. If that needed to pick up in a big hurry, we would be in trouble. As you can see by my testimony how many shops we have lost in this country. That will not be gained back.

Once we lose that employee base, we don't just say we are going to be a manufacturing country again. Again, we have to take away the attractiveness of the large businesses going over to China and setting up shop because it is further taking away from our ability to manufacture here.

Mr. LIPINSKI. And once we cannot produce those things we need to defend ourselves, we really have lost our defense if we are relying on other countries for those types of things.

Now, the other thing I want to get into is the currency manipulation. It made news recently that there is essentially a battle in NAM. The small manufacturers were able to win over, at least up to some point and it is still in process, support for H.R. 1498, the Hunter and Ryan Bill, that would apply U.S. countervailing laws to countries that manipulate their currencies.

The question I want to ask each one of you is do you think—this is certainly a bill that I support. Do you think that this is good legislation? Would this definitely be helpful? Obviously it is a battle between the small manufacturers and the larger manufacturers. The small ones are the ones who really supported this in NAM, the larger ones did not. I just want to ask each of you what you think of that bill.

Mr. Goodpasture.

Mr. GOODPASTURE. There is a good reason NAM wouldn't support that is because a lot of the large business. They have really become an organization that are large business, not NTMA, small business. A lot of NTMA used to be part of NAM and they have dropped out because a lot of their customers have picked up and moved to China so there is a reason, I think, they would not be in support of that.

How much that would help, I think it is a start. I still think there are a lot of issues as far as controlling and how much the yuan is actually—I saw so many prices being structured when I was in China that didn't go along with the yuan rate so I don't know. I think the whole thing is we have to make it less attractive for our major corporations here in this country to go to China.

Mr. LIPINSKI. Mr. Russell.

Mr. RUSSELL. Unfortunately, sir, I must apologize. I am not familiar with that house bill but, if given the opportunity to review it, I would be glad to respond at a later time.

Mr. LIPINSKI. Thank you.

Mr. Duggan.

Mr. DUGGAN. Sure. I was at that NAM meeting, as a matter of fact. The collective position of NEMA as an umbrella organization is that the currencies of major economies should be set by market forces. At that meeting, though, NEMA has members on both sides. I think we all agree that congressional pressure is helpful to all manufacturers, administrative pressure on China and talking to China is helpful but we unfortunately could not arrive on a consensus and NEMA abstained on that vote so I am afraid I can't give you a good answer.

Mr. LIPINSKI. Mr. Duesterberg.

Dr. DUESTERBERG. Mr. Lipinski, I think it is an excellent question.

Dr. DUESTERBERG. We are not a member of NAM. We are an independent organization and not part of that discussion. It is my view that the Hunter Ryan Bill is a very blunt instrument and I don't believe we are ready to use that yet. The problem is we have other instruments available to us and we simply haven't tried to use them. It is very clear in the articles of both the international monetary fund and the World Trade Organization that currency manipulation is a prohibited action.

The administration every six months has an opportunity to make a declaration. In fact, they are required to make a declaration to the Congress about whether or not any countries are manipulating their currencies with a view to enhancing their own commercial advantage. They have systematically hunted on that decision. It is quite remarkable that they have. I think the pressure needs to be on the administration.

We do have a new Treasury Secretary who at least has made some preliminary signals that he is sensitive to the problems created by currency manipulation. We could be smarter about trying to attract some international support for this position. The Europeans, for example, have hid behind us for years on this issue. Now they are facing a trade deficit of as much as $150 to $175 billion this year with China so it is becoming in their interest.

The Japanese are losing market share to the Chinese. We don't have to do this alone. We could go to the World Trade Organization, bring an action and try to get some international support for us. I think we ought to go that route first and try in a vigorous and systematic way to use the tools that are already available to us before we go down the path of a really blunt instrument.

Mr. LIPINSKI. Thank you.

Mr. Coley.

Mr. COLEY. Yes, Mr. Chairman. I also have to apologize that I know little or next to nothing about NAM or how it relates to my particular industry if it does at all.

Mr. LIPINSKI. I certainly understand if you came up to me and honestly asked me about some bill that I may not know anything in particular about either. If you ask me about cotton I couldn't tell you a whole lot about that so I understand. Thank you all.

Chairman GRAVES. Mr. Chabot.

Mr. CHABOT. Thank you, Mr. Chairman. I want to apologize for not being here to hear the testimony but, as oft times happens around this place, we have several hearings going on at the same time and I will review your testimony. Just a couple of questions.

First, relative to counterfeiting, Mr. Duggan, could you comment on what actions private companies are taking in the U.S. and abroad to combat counterfeiting? How big a problem is it?

Mr. DUGGAN. Private companies are doing things like, for example, if a product like this when it gets counterfeited sometimes they undergo—often they will undergo the expense of changing the packaging and then they inform the distribution chain that, "Look, the new packaging looks like this. If it is not this, it is not genuine." That strategy worked for a while.

The problem is that the counterfeiters got very good at very rapidly intimating the packaging so that didn't work. What they are doing is expending money where they can on investigations. In other words, their sales force will go around the United States, around the world, and they will see something that is not quite right. Then they will do some investigating on their own and then if they think it is serious enough, they will actually go to professionals, someone in country or someone in the United States that is in the business of chasing this down.

I think Tom referred to before they get into the problem of cost benefit. In all these companies brand protection is not a revenue center. It is an overhead. While over the long-term it certainly makes sense to do it, in the near and mid-term they go, "Well, we know we are getting ripped off but how much do we spend to solve this problem and then what about the next one?"

Some of the other things they are doing is inscription technology. You probably have seen holograms. I haven't seen this so much in the auto parts industry necessarily but some where you will see holograms or other types of inscripted material actually built into the product.

Then what you do is give the people in your distribution chain some sort of a reader so they can wave it across and they can tell.

Those are the services and the kind of products that they are doing. They are spending resources on it but, again, in some companies, medium companies in particular, but as well as in big companies it is not a revenue center and margins are small and it is very difficult to manage the cost of protecting your brand.

Mr. CHABOT. Thank you. My other question I would ask any of the panel members to comment on this if they would. If you already touched on this in your testimony, again, I apologize, but relative to the expectation by some Chinese either government officials or otherwise that they be, for lack of a better term, paid off or bribed, that sort of thing.

Some of the other countries are much more willing to look the other way than the United States is. Could you either comment on any instances that you have experienced in your own companies or yourselves and in your own experience, or stories that you have heard that you believe are credible from others where they have had a situation where this is something they have had to face. I will invite anybody who wants to talk about this.

Mr. RUSSELL. How much time have you got?

Mr. CHABOT. I will ask the Chairman. I am sure he will give us enough to hear the response.

Mr. RUSSELL. I will ask my counsel to nudge me if I start to digress or chase rabbits in too many different directions at once. I

have had opportunity to have conversations with my peers professionally with Oakley sunglasses, Nike shoes, Anheuser Busch, Harley Davidson. Those last two entities don't have the level of irritation that Oakley and Nike and Auto Meter have encountered. I know that the gentleman at Oakley has a budget for IP rights enforcement that has gone from zero dollars.

I don't know the years. Don DeKeefer, my counsel, could probably better speak on this. It is now over $5 million a year that he spends just investigating or examining counterfeit infringing goods worldwide, primarily manufactured in China.

Oakley is not necessarily a small business but I use that as a—he has told me in personal conversation on the phone that his budget now is over $5 million just for the investigation and enforcement of his rights worldwide. If you are a small business manufacturer, like I really have a strong degree of empathy for Mr. Goodpasture here, innovation is the key that is going to drive our economy. There is no two ways around that.

Mr. Goodpasture is presented with an opportunity here to develop a product or a service and he can find a way to be cost advantageous or cost competitive and still maintain a good profit margin which enables him to hire people to put dinners on tables in homes in Liberty, Missouri. That is part of the American dream.

He can't afford necessarily to hire, to expand, to become more competitive because he is spending money that instead of going to R&D to serve his purposes is going to brand protection, or IP protection or investigation. That has diminished his capabilities as a business enterprise. That is the affect that a lot of American companies are feeling right now.

You spend anywhere from $15,000 to $30,000, I will say, in my experience securing a utility patent. That is an investment, especially if you are a small manufacturer, if you are employing 20 people. Auto Meter employs 200.

After you have made that investment for that patent, the idea that you have to spend 10 times that amount simply to enforce it as well as the costs that are incurred going around trying to find out who is infringing it and the litigation cost involved, it would give, I am certain, a number of small manufacturers good cause to say, "What is the point?"

My personal feeling, sir, is if we lose small manufacturing in the United States, we have lost a basic bedrock element of the American economy. It was the small manufacturers going back to the times of the Revolution that decided they weren't going to pay the Stamp Tax. It was the small manufacturers that decided to leave their homes for the time being to their sons while they fought in the Civil War.

It was the small manufacturers that really provided services to the big companies because the big companies aren't flexible enough, don't have the knowledge, don't have the experience or whatever. The cost of intellectual property rights enforcement against counterfeiting and pirating, and let's not even stop to consider what should happen if a small manufacturer is named in a litigation for a wrongful death, per se.

Even though he may be vindicated after a considerably expensive defense trial, what has happened to his brand as a result of the

negative PR that has gone with that, how does he recover that? I can't emphasize enough this issue.

Mr. CHABOT. Mr. Chairman, I don't know if I have any time left or not and I appreciate the response. The one thing that wasn't covered that I was interested in was basically the desire of Chinese officials or others to require bribes, for lack of a more politically correct term here, in order to do something that one would expect a person to do in this country because it is their job.

They want to be paid off basically and my understanding is our rules and laws, etc., are much stricter than are being enforced by the French and others and, therefore, we have a competitive disadvantage as a result of that. If any of the other members have heard instances or have some sort of knowledge about that, I would be interested to hear your comments.

Mr. DUGGAN. In our brand protection meetings, and this is a collection of peer group of executives that are involved in brand protection and intellectual property. They do talk about things like that but I think, at least in the companies I have encountered, it seems strange but they may not even know that there is a law against bribes but they are not going to pay them because they generally—again, my impression of the people I talked to is, "I can't do this in the U.S. so I am not going to do it here."

You know, I think if you ask they would say, "I don't know if there is a law against it but we are not going to do it." Do they compare notes with their competitors, the Germans and the French? I think some do. You do hear talk like that, "Oh, everything is fraudulent. We don't do that." I don't really know about others, German, French, Japanese.

It is my general understanding that, yeah, you are right, they are more lose about that and more strict about it. It is a factor. It is hard to say how much of a factor that it is. They will refer to more, particularly in provinces and towns and cities, where basically things are run, you know, you can tell that the business owners and the mayor and the municipal authorities and the people doing licensing.

They have all lived in the same village or province for generations. They all know each other and you are an outsider. You are at a disadvantage even if you are providing jobs and even if you do have a partner.

One thing that does happen, I don't know if it is a cash bribe but it is very common that, let's say, you want to do business in a particular area, either sell or invest or something like that, they basically hook you up like some kind of a shotgun wedding and say, "If you want to do anything here, sell or manufacture, you are going to have to work through this person." Very often that person is someone who is acquainted with the local officials.

Dr. DUESTERBERG. Could I comment, Mr. Chairman? I have heard lots of anecdotes about activities of various sorts. In a political environment like that of China, which is basically an authoritarian system, there are ample opportunities and you see even the local people who are affected by mal-administration of justice and favors being given to local officials and riots all over the place that are not widely reported.

There is a group Transparency International that you probably know of that endeavors to have a systematic measure of how much bribery is going on. I don't have at the tip of my tongue the latest rankings but I know that China doesn't rank very highly in that regard. I provided a number in my testimony about how long it takes to get the average licenses to open a business in China compared to the United States it is 363 days basically a year. The average in the United States is 70 so each day provides an opportunity for a local official in an authoritarian economy to exercise some mischief.

I think Brian's point, the last point that he made, is also an important one. There are other ways that are sometimes above board and sometimes not above board that the Chinese try to extract some advantage out of companies doing business there. Perhaps that is even a bigger problem. General Electric wants to sell power plants. The Chinese will negotiate until the cows come home to try to get a transfer of the most sensitive technology that General Electric has.

That is a very common practice. You want to set up a cell phone factory. You want to sell them Boeing aircraft. They want to produce part of it and they want to have the technology that goes along with that. Because it is an administered licensed based economy, companies have to make a determination whether or not it is worth succumbing to their demands for transfer of technology or taking on local partners which frequently will steal the technology that they learned. I think it is still a rather large problem.

Mr. CHABOT. Thank you very much.

Thank you, Mr. Chairman.

Chairman GRAVES. I want to thank all the witnesses for coming in today. Some of you have traveled a long ways. I think it was very good testimony. This is actually the second hearing we have had on this particular issue and we want to continue to shed light on the problem and continue to try to pressure ourselves, the administration, Congress into paying more attention to this issue and try to get something done about it.

I think we have some great opportunities with China when it comes to trade but we have to have a level playing field as many of you have pointed out. Again, I want to thank you for being here. I appreciated all your testimony.

[Whereupon, at 11:32 a.m. the Subcommittee adjourned.]

Good Morning and welcome to the joint Rural Enterprises, Agriculture and Technology Subcommittee and the Tax, Finance and Exports Subcommittee hearing. It is my pleasure to hold this hearing with Chairman Bradley as we explore the question, do the Chinese trade fairly?

Trade with China has grown faster than with any other U.S. trading partner. Currently, China is our third-largest trading partner, the second-largest source of U.S. imports, and the fifth-largest U.S. export market.

The growth of the Chinese economy, in particular their exports to the United States, has reached record levels and has created a trade deficits of roughly $202 billion in 2005.

Some of the reasons for these discrepancies are as follows.

First, since 1994, the Chinese government has kept its currency pegged at 8.2 yuan (pronounced: u-en) to the dollar. While in recent years, the dollar has weakened, the yuan has remained the same against our currency. Many economists estimate that the yuan is undervalued by as much as 40 percent, which means Chinese manufactured goods are 40 percent cheaper than their competitors.

Under intense pressure, China announced that it would appreciate the yuan to 8.11 yuan to the dollar, an increase of 2.1 percent, as well as pegging its currency to a basket of currencies rather than only the dollar on July 21, 2005.

While I am not an economist or mathematician, if the yuan was 40 percent undervalued previously, then this slight adjustment still has the currency undervalued by 38 percent. I do appreciate that China has moved slightly by allowing its currency to increase by two percent, but much more needs to be done to level the playing field.

China has experienced economic growth, gains in productivity, a large export sector, and increased foreign investment. Their currency manipulation gives their manufacturers an advantage and creates an enormous disadvantage to ours. It's about time they stop cheating and start playing by the same rules as other countries.

Second, theft of intellectual property rights is another significant problem that US companies must take into account when dealing with China. It is estimated that counterfeits constitute between 15 - 20 percent of all products made in China and account for about 8 percent of China's GDP. It is also estimated that US companies lose $25 billion annually to copyright violations.

I've heard it said that if you are a manufacturer and the Chinese are not copying your products, you are not running a successful business.

While many people believe that this problem is restricted to purses or polo shirts, it is only the tip of the iceberg. Many people believe that it is a victimless crime; unfortunately, Chinese counterfeits or pirated items can impact our safety.

More and more often car parts, aircraft parts and even drugs are being copied. People buy what they believe are legitimate items only to find out later that their purchases were counterfeits. If this trend continues, more people will be harmed by fake medicines, faulty mechanical parts and even exploding batteries.

Worldwide, the market for counterfeit goods is growing and expanding. Global sales exceed $500 billion annually, although China is the biggest culprit.

Over the last two decades the U.S. has pressed China to improve its protection of intellectual property rights (IPR). While China has passed new laws that provide protection of IPR, it has done little to enforce these laws, allowing for rampant piracy and counterfeiting. China needs to crack down and be an active part of the solution.

We need to ensure that US firms compete on a level playing field in the global market and not be at a competitive disadvantage. These unfair barriers not only affect our economy but job growth, much of it fueled by small business, in this country.

I am pleased to recognize Representative Barrow for his opening statement.

Subcommittee on Tax, Finance, & Exports
Opening Statement of Chairman Jeb Bradley
Hearing:
Does China Enact Barriers to Fair Trade?

May 26, 2005

Good Morning. Thank you all for coming today. I would especially like to thank those of you who have traveled great distances to be with us here today.

I am also very appreciative of the Gentleman from Missouri, Chairman Graves, for agreeing to work with me on this hearing. I am looking forward to working with him, and all of you on the issues raised here today. Unfortunately, I have a scheduling conflict that is going to keep me from staying throughout the entire hearing but I am looking forward to participating for as long as I can.

As you all know, over the past two decades China has grown into a strong international competitor in the world wide trade market. China's emergence as a leading world economy has provided significant new opportunities for American exporters, and United States exports to China have risen sharply in recent years.

Trade between the US and China, which totaled only $5 billion just over two decades ago, rose to $285 billion in 2005. "China is now the third largest United States trading partner, our second largest source of imports, and our fourth largest export market. With a huge population and a rapidly expanding economy, China is becoming a large market for United States exporters to tap into. Yet, commercial ties between the US and China have been strained by a number of issues, including our surging trade deficit with China (which totaled $202 billion in 2005), China's refusal to float its currency, and failure to fully comply with its World Trade Organization (WTO) commitments, in particular, China's failure to provide protection for United States intellectual property rights.

Intellectual property protection is a major area of concern for United States exporters to China. According to the United States Patent and Trademark Office, China is the largest single source of seizures of infringing products by United States Customs—roughly $62.5 million, or 66% of total goods seized, in fiscal year 2003.

In 1991, the United States threatened to impose $1.5 billion in trade sanctions against China if it failed to strengthen its IPR laws. Although China later implemented a number of new IPR laws, it often failed to enforce them, which led the United States to once again threaten China with trade sanctions.

The two sides reached a trade agreement in 1995, when the Chinese government pledged to take immediate steps to stem IPR piracy by cracking down on large-scale producers and distributors of pirated materials and prohibiting the export of pirated products. The agreement also mandated the establishment of mechanisms to ensure long-term enforcement of IPR laws and providing greater market access to United States IPR-related products.

While some progress has been made between our two nations in this regard, these new mechanisms are not being rigorously enforced by Chinese officials, leading some industry analysts to estimate that IP counterfeiting and piracy in China cost United States copyright firms $2.3 billion in lost sales in 2005.

It is my hope that our two nations can continue to work together to ensure a level playing field in our commercial relations. I am very eager to hear the testimony to be presented today, and again, thank you all for being here today. Thank you, Chairman Graves.

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Testimony
of
Tom Goodpasture

President

Pride Manufacturing – Liberty, Missouri

Before the Joint Subcommittee Hearing of the House Small Business Rural Enterprise

Agriculture and Technology Subcommittee and Tax, Finance and Exports Subcommittee

"Chinese Barriers to Trade: Does China Play Fair?"

July 20, 2006

Testimony
Tom Goodpasture
President, Pride Manufacturing
Before the Joint Subcommittee Hearing of the House Small Business Rural Enterprise, Agriculture and Technology Subcommittee and Tax, Finance and Exports
"Chinese Barriers to Trade: Does China Play Fair?"
July 20, 2006

My name is Tom Goodpasture – President, and owner of Pride Manufacturing Co., Inc. I started our machining job shop in Liberty, Missouri in 1997. Our company has grown to 28 employees and we service the machining needs for the following key industries: automotive, defense, railroad, medical, aircraft, computer and construction.

I appreciate the opportunity to discuss China's barriers to trade and its impact on manufacturing across the country and especially in Missouri.

I am an active member in the National Tooling & Machining Association (NTMA) and through this testimony hopefully I can voice the concerns of our company and our 1,600 member companies across the nation. NTMA is one of the largest metalworking associations in America. It consists primarily of small- to-medium sized companies with average employment of 27 employees and average sales of 4 million dollars.

The manufacturing sectors hardest hit by ***the China factor*** are the tool, die and mold industry, and the precision-machined parts industry. Every product that is manufactured is formed by a tool, die, or mold made by our industry. Precision machining and tooling industry is truly the backbone of manufacturing.

The precision tooling and machining industry operates in a very competitive global marketplace. The industry has experienced a massive shift of production and orders to low-cost overseas competitors. Many of the big name / large US manufacturing firms have picked up and moved plants, or work to China with little regard for communities, employees & families. Vendor chains previously supplying tooling, components and assemblies to these plants while in the states have lost a tremendous amount of business.

I visited with Kim Hayden of Supreme Tool & Die in St. Louis a few weeks ago. Their company was so negatively affected by the amount of work going to China that their employment was forced from 65 to 32 almost overnight. Their sales revenue was cut in half, and they have gone through some very difficult times. By making huge adjustments they have survived and that's a success story.

One small die shop in Portage, Michigan lost 30% of its business due to the recent outsourcing by the Big Three automakers to China. The owner estimates that labor costs in China are one-tenth as much as those in the United States.

As component industries and design work follow assembly lines to China, key elements of the U.S. industrial base are beginning to erode. American plastic-molding and machine-tool industries have shrunk dramatically. When our members make their sales calls, they find their traditional customers have gone out of business, moved to another country—most likely China—or are unwilling to make the new investment in sophisticated and productive equipment.

Nationwide, the National Tooling & Machining Association reports that 28 percent of the country's toolmakers have shut their doors since 1998. In fact, in the state of Missouri, we have gone from 239 shops down to 162 shops, that represents a 48% reduction of its tooling and component shops from 1998-2004, according to the latest data from the U.S. Bureau of Labor Statistics.

As I talk to shop owners across the nation the plea is common, ***"level the playing field".*** Most in our industry have endured some hard times. We are not afraid of competition, ***but make it fair competition***.

If U.S. manufacturing is to compete, we need to level the playing field. Manufacturing produces some of the highest paying jobs with the best benefits in the country. At Pride Mfg. our "cost burden" over wages, with benefits, averages in excess of 35 %. There was an owner of a machine shop at our meeting who just received his company healthcare renewal and it was increased by 40% this year alone. We need the *Small Business Health Plan* legislation passed by Congress so we can negotiate association health plans to reduce costs. One employee's health issue should not rate an entire organization to the point that health care is unaffordable.

Currently it is almost impossible to compete with the low wages being paid in China. The only way we can keep our costs as low as China's is by having automation that runs unattended and requires 0 labor. That is how many of our businesses have survived the recent hard times. At Pride, we have invested in robotic equipment and Swiss Turn Lathes that run unattended "lights out". Our machinists have now become technicians as well. I'm proud to say that currently, we are producing component parts 24/7 for our local customer, which is being sold to China to be used in the Light Rail being constructed from Beijing to Shen Yang. That investment is huge to our small business and we could not have done it without accelerated depreciation.

American manufacturers need the *R&D Tax Credit.* This critical tax credit, which expired at the end of 2005, needs to be reinstated retroactive so we can continue making investments in automation. This will offset high labor with 0 labor so we can compete in the world market. After these investments into technology are made, we need the *Estate Tax* altered so that the next generation does not lose the business to taxation. These are things that could be done to level the playing field.

Last fall, I spent nine days in China on a NTMA Study Mission. I found that what we see and hear on the American news does not accurately reflect the China that I saw. Both Beijing and Shanghai are ultra-modern cities comparable to any city in the U.S. The construction going on there is like nothing I had seen before. I was told they complete one power plant of some size in China every single day.

Most of the manufacturing jobs are not the slave labor sweatshop jobs that I would have envisioned. Although China has few labor laws controlling safety, most of the machines were guarded to protect the worker. I noted a few unsafe conditions, but for the most part they take a very practical view of safety, in spite of having no regulations.

Technology that I was hoping we could keep from China, is already there in abundance. The German, Swiss and Japanese influence in the plants is apparent and it is obvious that they were there long before us. Some of the shops are very modern with the same technology that we have available. Although many of the laborers are young and less skilled that is rapidly changing. Firms from the U.S. and other countries, setting up plants in China, send teams of engineers over to accelerate plant operation, in turn accelerating the Chinese manufacturing economy. I came away from that trip with two thoughts:

1. ***Whatever the United States decides to do or not do about manufacturing in China would make little or no difference to the Chinese.***

2. ***The United States, because of our adversarial position, is missing a huge opportunity to sell to the commodity market in China. While many other countries are selling to thm.***

China made a conscious decision several years ago to be a manufacturing community. They have been very successful in drawing large corporations from every major country in the world, to their low cost surplus labor society, while allowing them to escape the regulations that haunted them in their home countries.

Does China play fair? No. Factor in the alleged subsidization of the Chinese government, currency manipulation, no safety and environmental standards, and low wages, it is clearly not a level playing field.

Also in many instances, payment terms are different. Chinese companies require as much as 90%, if not 100% of the tool to be paid for prior to shipment from China. In contrast, the U.S. tool shops are forced to wait months and in some instances years, if ever, to get paid on their tools. Bigger businesses are essentially forcing small businesses to carry their debt in this country.

It has become well known that Chinese manufacturers have no problem creating exact duplicates of components and equipment without regard for American intellectual property and patent laws. We have several area food equipment manufacturers that sell on the world market, whose products were reproduced and sold by China manufacturers. Even if the counterfeits are not sold in America, they have stolen these company's market share elsewhere that took years and large investments to create. The Chinese government has made little progress in dealing with this issue that has devastated many U.S. companies.

Does China manipulate the currency? All evidence would say that it does. It is obvious that China's economic strategy over the past decade has been to keep the value of its currency low, boosting its exports and holding down imports. It is indisputable that there is no free market for the yuan. Despite rapid economic growth, rising productivity, soaring exports, and huge foreign investment inflows – all factors that would normally cause a currency to appreciate – China has kept its currency pegged at approximately 8.00 yuan to the dollar since 1994.

Furthermore, companies relocating to China can benefit from the currency manipulation that is, in reality, a tremendous subsidy. When this subsidy is added to the very substantial differential in labor costs between our two nations, Chinese products become irresistible, and it makes investment in Chinese manufacturing extremely attractive.

Chinese prices are obviously adjusted according to what they can charge. If $100.00 US at the current exchange rate of 7.99 RNB value = 12.51 RNB. Then why do I have to pay an average of $125.00 for a decent hotel room in Beijing or Shanghai? That would be the equivalent to almost $1000.00 in the states. Why does the average machined part purchased from China cost 40% - 60% or more of our price when it should cost 12.5 %? You may still be able to buy junk on the streets cheaply, but things that matter just do not follow the exchange rate.

What to do about China is a complicated issue. China has made the wise choice to purchase their future in the world of manufacturing and thus far have been very successful – that's history. Now we are left with some hard truths: we do not have enough mills to produce the raw stock to supply our own needs. Prices are going up in some cases at a rate of 30 – 40 % for steel, stainless, aluminum, brass and copper or more just because there is no supply.

Although the actual numbers are being disputed, China is still graduating many more engineers than the U.S. We have an aging and depleting manufacturing employee base that will reduce drastically over the next decade.

I urge our government to do what China has done. Make a conscious decision to keep a strong manufacturing base in America. We have lost ground. We must do everything that we can to regain our position and maintain it. In years to come without a strong manufacturing base our security and defense could be at risk.

China has not played fair; we cannot change the past. We must take hold of our future, and not allow our security and defense to be in the hands of China or anyone else. **We must make American manufacturing strong and competitive.**

I appreciate the opportunity to testify before these committees and am happy to answer any questions.

Thank you.

TESTIMONY OF DONALD E. DEKIEFFER ON BEHALF OF AUTO METER PRODUCTS, INC., SYCAMORE, ILLINOIS BEFORE THE HOUSE COMMITTEE ON SMALL BUSINESS JULY 20, 2006

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[PowerPoint 1. – Opening slide.]

Auto Meter is appearing today as a member of the Specialty Equipment Market Association (SEMA). SEMA, which was founded in 1963 and has 6,817 member companies, represents the $34 billion specialty automotive industry. This industry provides appearance, performance, comfort, convenience and technology products for passenger and recreational vehicles. For more information, contact SEMA at 1575 S. Valley Vista Dr., Diamond Bar, CA 91765 or visit www.sema.org.

A. Brief History of Auto Meter, its Products, and its Trademarks

Complainant Auto Meter is a medium-sized company headquartered in Sycamore, Illinois that manufactures automotive measuring devices – gauges and tachometers – for the high-performance automotive aftermarket. Since the 1950s, Auto Meter has been in the business of designing, manufacturing, marketing, and selling a full line of automotive measuring devices including oil pressure gauges, oil temperature gauges, water temperature gauges, vacuum gauges, ammeters, volt meters, fuel pressure gauges, fuel level gauges, speedometers, and tachometers.

Auto Meter's products are used in virtually all types of automotive competition. For example, ninety-eight percent of cars on the NASCAR circuit today use Auto Meter's products.

[PowerPoint 2. – NASCAR car displaying Auto Meter decal.]

Auto Meter's products are also widely used in drag racing, circle track racing, off-road racing, and other types of automotive racing, as well as in certain marine and other high performance applications. Auto Meter's customers include those directly involved in automotive racing – professional and semi-professional racers, car owners, mechanics, and race and show car builders – and the high performance enthusiasts who follow these sports and who install in their own vehicles the products used by the pros they see at the race track.

Auto Meter, which was started in 1957 as a small, family-owned business manufacturing high-performance tachometers, is today a $45 million enterprise with approximately 300 employees. Over time what began as a shoe-string, kitchen-table operation has developed into the premier brand in its field. Today, Auto Meter's products are the gold standard for quality, performance, and customer service in the high-performance aftermarket, and have been for many years. In 2003, it was purchased by the St. Louis-based Harbour Group, which owns it today. One thing hasn't changed. Auto Meter was, and remains today, a U.S.-based manufacturer.

A half-century ago when Auto Meter set out to break into a market dominated by a few established brands, it followed a two-pronged strategy for gaining recognition for its high-performance tachometers (and, later, gauges). It developed the most

technologically advanced products in the industry to satisfy the demands of high profile racing teams, and it provided those racers with unparalleled product support, following the racing circuit and making on-the-spot repairs of its products at race venues. In order to capture the much larger part of the market comprised of automotive enthusiasts, who modeled their buying decisions on what the pros were using, Auto Meter redesigned its products to give them a look that was not only distinctive but readily identifiable from a distance, making the instruments used by the racers, in effect, their own billboards.

One of those distinctive designs involved the bezel – the highly visible ring on the front of the instrument. **[PowerPoint 3. – Super Bezel drawing and instrument.]** Auto Meter's "Super Bezel," introduced in 1968 and today the subject of a federally registered trademark, constituted a dramatic departure from the status quo, which was the so-called "SAE bezel,"[1] the minimalist design used by most manufacturers at the time. In contrast to the SAE bezel, the Super Bezel's extra height and exaggerated features (its inspiration was the intake for a jet engine) made it instantly recognizable to spectators at racing events.

[PowerPoint 4. – Comparison of SAE bezel and Super Bezel.]

[PowerPoint 5. – Photographs of Super Bezel products in racing cars.]

[PowerPoint 6. – Photographs of Super Bezel products in racing cars.]

[PowerPoint 7. – Photographs of Super Bezel products in racing cars.]

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[1] Recommended by the Society of Automotive Engineers.

Auto Meter has retained this design unchanged down to the present, where it still serves as a trademark on Auto Meter's logo and on more than 80 percent of Auto Meter's products, with the result that the Auto Meter look is a fixture of the high-performance automotive scene. **[PowerPoint 8. – Auto Meter's Logo Trademark.]** Auto Meter's Super Bezel products are, in short, the Coca-Cola bottle of their industry.

In 1976, Auto Meter introduced a 5-inch tachometer, the first in the industry. **[PowerPoint 9. – Auto Meter Monster Tachometer.]** These so-called "Monster Tachometers" contain a number of design elements that, like the Super Bezel, produce a look that is visually striking and instantly recognizable. A distinctive bezel, a prominent, metallic "shock strap," the exaggerated length of the rear housing, and, frequently, an oversized shift light combine to give Auto Meter's Monster Tachometer its distinctive profile.

[PowerPoint 10. – Photographs of Monster Tachometer in racing cars.]

[PowerPoint 11. – Photographs of Monster Tachometer in racing cars.]

Since introducing the Super Bezel, the Monster Tachometer, and other, similarly innovative and arresting designs, Auto Meter has remained in the forefront of its industry in terms of technological sophistication and constant innovation, while keeping the essential look of its products largely unchanged.

B. Foreign Manufacturers begin knocking off Auto Meter's products

Beginning in the late 1990's and accelerating by 2001, a flood of imported products that imitated the look of Auto Meter's Super Bezel, its Monster Tachometers, and its other trademarks and trade dress appeared in the U.S. market. In nearly every

case, the source was Taiwan, but many of the infringing manufacturers actually manufactured the copy-cat products in China.

[PowerPoint 12. – ProForm and Auto Meter Tachometers.]

[PowerPoint 13. – Auto Gauge of Taiwan and Auto Meter gauges.]

[PowerPoint 14. – Auto Gauge of Taiwan and Auto Meter gauges.]

[PowerPoint 15. – OBX Racing Sports and Auto Meter gauges.]

[PowerPoint 16. – Auto Gauge of Taiwan and Auto Meter tachometers.]

[PowerPoint 17. – Auto Gauge of Taiwan and Auto Meter tachometers.]

These infringing products misappropriate the distinctive look of Auto Meter's trademarks and trade dress – a look that is protected by federal and state law, and that has identified Auto Meter's products for decades. Some of these foreign copycats go much farther, copying other Auto Meter trademarks and even its installation instructions.

For example, in 1982, Auto Meter introduced an economy line of products, which it called its "Auto Gage" line and which it produced, in part, in Taiwan, to compete against low-cost imports. The "Auto Gage" name is federally trademarked. In 2000, one of the most persistent and most aggressive of the foreign copycat manufacturers began offering knock-offs of Auto Meter's products under the "Auto Gauge" name, adopted a copy of Auto Meter's trademarked Logo Trademark and other aspects of Auto Meter's products, and even resorted to copying the installation instructions for Auto Meter's products.

[PowerPoint 18. – Copying of Auto Meter's "Auto Gage" trademark.]

[PowerPoint 19. – Copying of Auto Meter's "Auto Gage" trademark.]

[PowerPoint 20. – Copying of Auto Meter's "Auto Gage" trademark.]

[PowerPoint 21. – Copying of Auto Meter's installation instructions.]

In 2004, Auto Meter's president, Jeff King, visited the factory of a Chinese manufacturer name Fenghua Hearty Motormeters Co., Ltd. ("Fenghua"). On display in Fenghua's show room, where it offers its wares to prospective customers, Mr. King found Auto Meter products bearing the Super Bezel, copycat products with the Super Bezel and Monster Tachometer trade dress, and products on the assembly line that bore the legend "Made in USA" on their dial face. Fenghua's catalog provides a sobering picture of Fenghua's capabilities as a manufacturer of infringing products. Fenghua claims to have an advanced production facility with an area 5,000 square meters, fixed assets worth ¥ 10 million, and *a capacity of 1.5 million automotive measuring devices per year*. Moreover, as Fenghua's catalog explains in broken English, "company export is main and the sell inside the country is complement," *i.e.,* the primary outlet for Fenghua's formidable production capacity is the export market, "including America," whiles its sales inside China are negligible.

[PowerPoint 22. – Genuine Auto Meter product displayed in Chinese factory.]

On the same trip, Mr. King also toured the production facilities of the Zhejiang Shaoxing Betung Instrument Co., Ltd. ("Betung"), a manufacturer of automotive

measuring devices located in Kegiao, Shaoxing, Zhejiang, China. There, he was shown, among the products that Betung was willing to manufacture for prospective clients, an Auto Meter gauge that Auto Meter had manufactured for an Auto Meter customer as a private label product. This gauge carried Auto Meter's registered Super Bezel Trademark and was identical to Auto Meter's Auto Meter-branded products except that Auto Meter placed the name of the private label customer instead of "Auto Meter" in the center of the dial face. Betung's manager explained that Auto Meter's private label customer had sent the gauge to Betung with a request that Betung submit a quotation for producing copies of the gauge and that Betung had provided the requested quotation.

[PowerPoint 23. – Copy of Auto Meter Monster Tachometer displayed in Chinese factory.]

C. Auto Meter's efforts to protect itself

Since 1999, Auto Meter has brought suit in federal district court twice against infringing imports. It monitors the market regularly for infringing products, and it has written scores of cease-and-desist letters. In 2003, it filed a complaint with the International Trade Commission requesting an investigation under Section 337 of the Tariff and Trade Act of 1930 against 19 manufacturers and importers to bar the importation of knocks-offs that infringed Auto Meter's trademarks and trade dress, including all the trademarks discussed above. In 2005, the ITC issued limited exclusion orders and a cease-and-desist order against all of the respondents that had not voluntarily ceased importing infringing products due to the investigation. In 2005, at Auto Meter's request, the U.S. Customs Service also examined several of infringing imports and issued a headquarters' ruling that they were counterfeiting Auto Meter's registered trademarks.

Since 1999, Auto Meter has spent well over a million dollars protecting itself against infringing imports, many of which are manufactured in China. Auto Meter has been assisted in this effort by the federal courts, the International Trade Commission and the Customs Service, as well as SEMA and other trade associations. Yet these products continue to enter the U.S. market, and every year Auto Meter loses tens of thousands of dollars in sales to these illegal products.

D. Consequences to Auto Meter of China's undervalued currency

It was an article of faith with John Westberg, son of Auto Meter's founder, Vern Westberg, and Auto Meter's president and CEO for more than 30 years, that Auto Meter products should continue to be manufactured in the United States, where they could provide manufacturing jobs for U.S. workers and a stimulus for the U.S. economy. As foreign competition brought pricing pressure to bear on Auto Meter, it responded by developing its economy Auto Gage line, which it had manufactured in Taiwan, to compete with low-priced foreign imports. But its flagship Auto Meter products continue to be assembled and produced entirely in the United States, at its facilities in Sycamore, Illinois and Pleasant Grove, Utah.

As with other U.S. business, keeping its production operations in the United States has become more and more difficult for Auto Meter as competitors from Taiwan and other Asian countries have increasingly shifted their production of gauges and tachometers to China, where they benefit from the under-valued yuan. The failure of those countries efficiently to police intellectual property rights, and the free rein given to foreign infringers in these countries to export their knockoffs and counterfeits to the United States, significantly and unfairly increase the pressure on Auto Meter and similar

industries trying to protect their markets and the jobs of their employees. In the past two years, this pressure has forced Auto Meter to retrench by closing its Ephraim, Utah facility at the cost of approximately 100 jobs and to shift those jobs to its other facilities. Nevertheless, 100 percent of the design, assembly, and calibration of its "Auto Meter" line of products continues to be carried out in the United States.

I would ask this committee to continue our government's efforts to compel China and other Asian countries to respect U.S. intellectual property rights and provide the means for U.S. companies to enforce those rights where the illegal manufacturing is taking place, rather than requiring companies like Auto Meter to defend their markets at the U.S. borders at great expense. These resources could otherwise be devoted to developing new products and new U.S. jobs to the benefit of U.S. consumers.

Remarks by Brian Duggan, Director of Trade and Commercial Policy for the

Motor and Equipment Manufacturers Association (MEMA)

before the House Small Business Committee

Subcommittee on Rural Enterprise, Agriculture and Technology and

Subcommittee on Tax, Finance and Exports

July 20, 2006

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The Motor and Equipment Manufacturers Association (MEMA) represents an industry of more than 8,000 manufacturers of motor vehicle parts, components, technology, tools, and related products. These manufacturers are known collectively by the term "automotive suppliers." Our industry supplies the products and technology used in the production of 13 million cars and trucks in the United States annually, as well as products used to repair and maintain the over 214 million vehicles currently on American roads and highways. The automotive and heavy duty supplier industry employs approximately 1.3 million American workers in 12,000 plants across the country, shipping products throughout the United States and to global markets.

Many of the business and financial problems caused by Chinese counterfeiting and patent infringement of auto parts are occurring across the industry. This testimony will explain the dangers posed by trafficking of counterfeit auto parts, including consumer safety hazards, the loss of brand image, and the loss of export markets for American suppliers. The damage done is disproportionately serious for small businesses because they can least afford the lost sales on a limited number of brands and product lines and have fewer if any resources to protect their trademarks and patents, especially in China. Lastly, this testimony will provide our views on certain work underway through the STOP program and other Federal efforts to help industry.

Product counterfeiting and other willful intellectual property theft is not a trade problem or a competitiveness problem in the usual sense. Product counterfeiting and IP theft is first and foremost a global crime. American automotive suppliers are now, on top of everything else, competing with global criminal networks out to steal from legitimate producers that play by the rules and work to provide value and service to their customers in the United States and abroad.

To the extent the People's Republic of China is now used as a hub by criminals for production and trafficking of counterfeit automotive parts and components, it is offloading the cost of law enforcement and public safety to American industry and the U.S. Government. Automotive suppliers have been targeted by Chinese-made counterfeit products for several years. Just as Chinese manufacturers have become more competent in the manufacture of legitimate goods over the past several years, they have also become more competent and aggressive in manufacture of counterfeit goods. Patent infringement and product counterfeiting are the primary forms of intellectual property violations against all American automotive suppliers.

Private companies and industries are well suited to measure sales, cost of production, and profits. We are not, however, well suited to measure global crime, and therefore, there are unfortunately no authoritative estimates of the production and sales of counterfeit automotive parts and components in China, the United States and around the world. Nevertheless, industry experience does indicate that the parts most often counterfeited are for the repair and replacement market products which

tend to sell quickly in high volumes, as well as parts that are easiest to copy and provide the best profit margins. Examples of such parts include spark plugs, shock absorbers, oil filters and fuel filers, fuel pumps, brake components (including pads and linings), suspension and steering components, body panels, bearings, wind shields, tires, headlights, taillights, engine mounts and other engine parts.

There are some astonishing and disturbing examples of product counterfeiting in our industry, including the following:

- Federal agents in Queens and Manhattan seized $700,000 worth of unsafe, counterfeit brake parts, taillights and other parts that were being installed by dealers on city taxicabs. The danger of installing critical safety parts on city taxicabs in New York is enormous.

- An investigation by one American automotive supplier found a company in China switching signs in front of their factory, making customers believe they produced legitimate branded parts. The Chinese producer further misrepresented itself to customers by using phony stationery and signs in the factory. This Chinese producer infringed on the trademarks of several American and European automotive brands.

- A Midwest automotive supplier reported lost sales from product counterfeiting of $40 million and additional legal costs of $5 million annually.

- An automotive supplier has been forced to take legal action in 40 cases against counterfeiters over a four-year period and seized or blocked imports of $5 million in infringing products.

- A Midwest automotive supplier reported a drop in sales volume of 40% in some of its product lines as a result of product counterfeiting. The loss in sales volume occurred primarily in the United States.

- Counterfeit oil filters made in China found in the United States contained cardboard instead of filter material and was illegally labeled "Made in the USA."

- A Chinese-based website has been barred from participating in America's largest automotive aftermarket trade show for trafficking counterfeit automotive parts and components.

A very typical counterfeiting case involves a Chinese counterfeiter manufacturing a product made to look like the genuine part, and also making an exact or nearly exact copy of the product packaging, including brand names, logos, color schemes, designs, product inventory codes, and often "Made in the USA" origin labeling. In many cases, however, the materials, workmanship and durability of the product are inferior to the genuine part. In the case of brakes, headlights, tail lights and other safety related parts, poor material and workmanship create a safety hazard.

Moreover, the inferior quality, durability and workmanship of counterfeit auto parts leads to another very serious problem for legitimate producers: brand destruction. When a customer unwittingly purchases a counterfeit product, and the product fails to perform and provide value, the reputation of the brand is diminished. The customer may refuse to purchase that brand again in the future due to the one bad experience. Measuring loss of customer good will – brand destruction – caused by fake parts is very, very difficult. The losses caused by brand destruction are as great - or even greater - to a company than the loss of sales caused directly by the original sale of the counterfeit auto parts.

Product counterfeiting is destroying export markets for American automotive suppliers and genuine American brands. The fact that Chinese-made counterfeit auto parts are sold quite openly and widely throughout China is well established. Chinese-made counterfeit auto parts are also widely seen in transit points and third-country markets, notably in Dubai, the United Arab Emirates, Egypt, Saudi Arabia, Singapore and Colombia. American manufacturers cannot export product or build their brands around the world if their products are already widely available in counterfeit form. This is a serious problem in China and many other developing markets.

The cost, time and complexity of defending intellectual property rights at home and abroad is a serious challenge for small and medium sized automotive suppliers.

Federal, State and international actions aimed at addressing this core problem deliver the most value to small businesses and deserve Congressional support. Maintaining a focus on law enforcement and actions that do not depend entirely on near-term changes in China (which is highly uncertain at best) are also a priority. Elimination of the production and trafficking of counterfeit goods in China is an ultimate long-term goal. In the meantime, meaningful near-term action is necessary.

The Federal Government has taken some very useful actions to combat trafficking in counterfeit goods that help industry. For example, the Department of Justice has increased the number of prosecutors in the field and deployed additional staff in Asia to increase enforcement. Also, the Department has distributed an industry guide to reporting intellectual property crime. The FBI has increased the number of intellectual property undercover operations. These actions make Federal assets more accessible to small businesses. "Victims Conferences," and legal seminars organized by the Justice Department and the Patent and Trademark Office provide specialized training and guidance to small businesses at no charge. The Patent and Trademark Office in cooperation with the Department of State is deploying intellectual property attaches to trouble centers around the world, including China. These attaches will be a resource for small companies that cannot afford foreign staff. More programs of this kind deserve Congressional support.

There are other Federal actions that, if done properly could provide a valuable service to small business and help them manage the high cost of protecting their

brands. Many small and medium sized automotive suppliers build their domestic and foreign sales by displaying product at trade shows. Trade shows are a long-standing institution in the automotive industry domestically and abroad. Counterfeiters, unfortunately, also reach current and potential customers through these events, at the expense of legitimate producers. On behalf of our members, MEMA and other private sector organizations are urging the Foreign Commercial Service (FCS) to conduct a targeted fact finding aimed at raising standards of intellectual property protection at foreign trade shows. In our request for assistance, we asked that this fact finding be conducted using the agency's overseas staff, and work with the private sector and the Patent and Trademark Office (PTO) to determine standards of intellectual property protection and enforcement at many foreign trade shows in developing markets where counterfeiting has been a problem.

Currently, FCS supports and endorses many trade shows abroad and has long-standing relationships with show organizers. Some reports from industry suggest, however, that many foreign show organizers take little to no action to help American companies who find counterfeits of their products on the show floor. Organizers of prominent trade shows in the United States enforce rules to remedy counterfeiting claims. We believe the FCS can perform an important service by conducting the fact finding requested by industry and leveraging its relationships with foreign show organizers to raise standards of intellectual property protection. We would ask this Committee to review this problem with the agency as this project goes forward and encourage them to collaborate closely with industry rights holders on this problem.

In conclusion, the automotive supplier industry and MEMA would like to thank the Committee for turning its attention to this problem and we look forward to working with you and your staff. I would be glad to answer any questions you many have.

"Counterfeiting is the Crime of the 21st Century." – The F.B.I.

A crime of global proportions: Interpol Secretary General Ronald Noble cited the seizure of $1.2 million worth of counterfeit brake pads and shock absorbers in Lebanon in May 2004, at a conference in Brussels. A subsequent inquiry found that profits from the sale of these products were destined for supporters of the terrorist organization, Hezbollah. Interpol General Secretary Noble said, "If law enforcement and governments focused on it, (counterfeiting) more, we'd find more evidence of it. It's a low-risk, high-profit crime area that for most governments and most police forces is not a high priority. And therefore criminals are more likely to want to get involved in this area rather than drug trafficking."

As companies competing in the global market place and playing by the rules, the members of the Brand Protection Council of the Motor and Equipment Manufacturers Association ask you to support stronger laws and stronger enforcement of American manufacturers' intellectual property at home and abroad

ABRO Industries Inc.
Affinia Group
Akebono Corporation
ArvinMeritor
Bendix Commercial Vehicle Systems, LLC
Chicago Rawhide, Inc.
Cloyes Gear and Products
Cummins, Inc.
Dayco Products, LLC
Gates Corporation
DaimlerChrysler/MOPAR
Dana Corporation
Delphi Corporation
DENSO Sales California, Inc.
EaglePicher/Wolverine Div.
Federal-Mogul Corp.
Flex-a-lite Consolidated
Ford Motor Company
Four Seasons, Inc.
Freudenberg-NOK
Grote Industries
General Motors SPO
Hella, Inc.
Horton, Inc.
Haldex Commercial Vehicle Systems, Inc.
Melling Tool Co.
Northern Engraving Corp.
Parker Hannifin Corp/Racor
Permatex, Inc.
Remy International
TI Grp. Automotive Systems
Shell Lubricants
TransPro, Inc.
Tenneco Automotive, Inc.
TRW Automotive, Inc.
Valeo, Inc.
Vector Mfg., Ltd.
Visteon Corporation
Webb Wheel Products
ZF N. Am. Operations

These are just of few of the hazards to American consumers and costs to automotive suppliers caused by counterfeiters.

Federal agents in Queens and Manhattan seized $700,000 worth of unsafe, counterfeit brake parts, taillights and other parts that were being installed by dealers on city taxicabs. The danger of installing critical safety parts on city taxicabs in New York is enormous. The persons arrested face up to 15 years in prison.

An investigation by one major American automotive supplier found a company in China switching signs in front of their factory, making customers believe they produced legitimate branded parts. The Chinese producer further misrepresented itself to customers by using phony stationery and signs in the factory. This Chinese producer infringed on the trademarks of several well-known American and European automotive brands.

One Midwest automotive supplier reported lost sales from product counterfeiting of $40 million and additional legal costs of $5 million annually. Another supplier has been forced to take legal action in 40 cases against counterfeiters over the past four years, and seized or blocked imports of $5 million in infringing products.

Another major Midwest automotive supplier reported a drop in sales volume of 40% in some of its product lines as a result of product counterfeiting. The loss in sales volume occurred primarily in the United States.

"Trade in counterfeit products exceeds $500 billion dollar per year." - The World Customs Organization

MEMA
Motor & Equipment Manufacturers Association

Testimony of
Thomas J. Duesterberg
President and Chief Executive Officer
Manufacturers Alliance/MAPI

Before the
Subcommittee on Tax, Finance, and Exports
and the
Subcommittee on Rural Enterprises, Agriculture, and Technology
of the Small Business Committee
U.S. House of Representatives

July 20, 2006

Chinese Barriers to Trade: Does China Play Fair?

Mr. Chairman and Members of the Committee, I want to commend you for holding this hearing on a subject of vital importance to U.S. manufacturers: whether we have adequate access to the growing Chinese market. The Manufacturers Alliance/MAPI represents over 500 leading manufacturing firms whose products range from basic materials to high technology products and associated services. The Alliance itself is primarily a provider of economic research and educational services for senior executives at our member companies. We do not presently, nor have we in the past 20 years, accepted any federal or state government grants or awards of any kind. While we are primarily a research firm, we do occasionally advocate public policies which benefit our member firms. Nonetheless, the views I present today are mine alone and do not necessarily represent the unanimous opinion of our members.

Access to the Chinese market is a timely subject because it represents the fastest-growing large economy in the world and is likely to remain so in coming years. Chinese manufacturers are increasingly competitors to U.S. firms in our home markets and in other global markets. We should recall that manufacturers account for the large majority of U.S. imports and exports: for example, U.S. manufacturers' exports are 76 percent of the U.S. total going to East Asia. Moreover, the Alliance projects that in the current year, China will overtake the United States as the leading exporting nation for manufactures, a startling turn of events, since as recently as 2001 China had only one-half the level of the United States for total exports of manufactured goods.[1] And it is not only in low-value added product sectors that China has become an export juggernaut, it is also challenging the United States and Europe in the production and export of high technology products. While the United States enjoyed a trade ***surplus*** as recently as 2001 in advanced technology products (ATP), by 2005 we experienced a ***deficit*** of $44 billion. China alone had a surplus of $47 billion in ATP products with the United States, accounting for the entire deficit in this area of manufacturing which is so crucial to our future prosperity and standard of living.[2]

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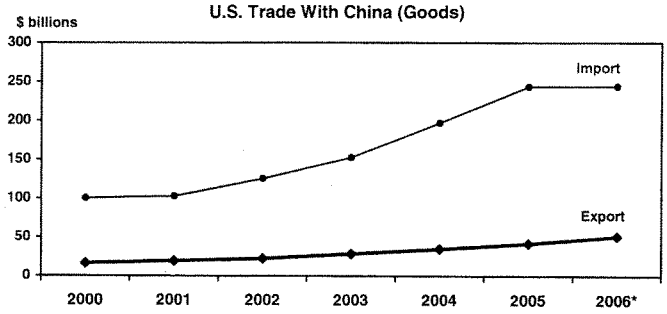
[1] See Ernest Preeg, *The Chinese Export Juggernaut in Manufactures Overtakes the United States and the Policy Implications* (Arlington, VA: Manufacturers Alliance/MAPI, March 2006), p. 1.

[2] *Ibid*, pp. 8-9.

Trade With China: What Explains the Slow Growth of U.S. Exports?

Chart 1 chronicles the tremendous expansion of our trade with China in this decade. What is particularly relevant to this hearing today is the relatively slow growth of U.S. exports to China. With an economy growing at 9 percent to 10 percent per year on a consistent basis and with capital investment growing at triple this rate, it would normally be consistent with past experience for a country like China to register import growth at a much higher rate, especially with its leading trading partner, the United States, which is the world's premier producer of capital goods.

Chart 1
U.S. Trade With China (Goods)



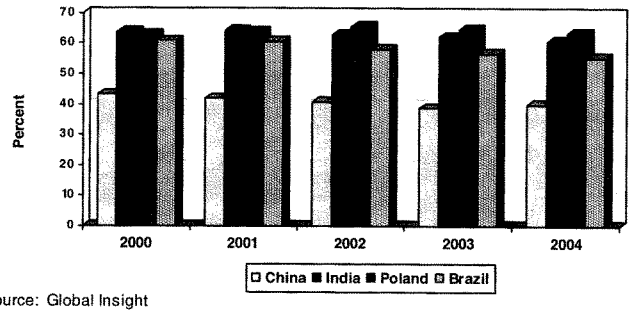
Source: U.S. Bureau of the Census
*Estimated

There are several factors contributing to this disproportionately slow growth in imports relative to exports in the modern Chinese economy. I will focus on these in some detail and then discuss possible policy responses to address them. First is the anomalous rate of private consumption by Chinese consumers relative to investment and government spending.[3] Household spending on items like cars, appliances, clothing, and other consumer items often drives foreign trade. Chart 2 compares household spending in China to that of three other larger developing nations: Poland, Brazil, and India. It shows a remarkable 21 percent difference in household demand in China relative to these three peer nations over the 2000-2004 period. Other Asian nations, such as Taiwan, Japan, and Korea, showed much greater levels of consumption at similar stages of development. Even today, other Asian nations viewed as employing export-oriented growth strategies, such as Malaysia, Thailand, and Indonesia, have significantly higher levels of household consumption relative to China. Some reasons for this anomaly include: lack of a "social safety net" and hence a need to save for education, health, and retirement expenditures; government policies to discourage rapid growth of consumption, especially in autos and housing; and an undervalued currency (which is discussed more fully below). Simulations done by my Alliance colleague Cliff Waldman project only slow to moderate growth of household consumption in China over the next decade.[4]

[3] See on this subject Cliff Waldman, *The Chinese Consumer of the 21st Century: Theory and Evidence* (Arlington, VA: Manufacturers Alliance/MAPI, June 2006), p. 1.

[4] *Ibid*, pp. 15-18.

Chart 2
Household Spending Share of Gross Domestic Product
China, India, Poland, Brazil



Source: Global Insight

Second, the United States is losing market share throughout Asia to regional suppliers. Between 2000 and 2005, the United States saw its market share—among the "big four" nations of China, Japan, Korea, and the United States—in the eight leading Pacific Rim nations (China, Japan, Korea, and five Association of South East Asian Nations [ASEAN] countries) fall from 38 percent to 26 percent. In the same period, the relative market shares of China, South Korea, and Japan all rose. Table 1 provides the relevant totals for exports and market shares of the four leading exporters. The Alliance projects that if recent trends continue, the U.S. market share in this region among the "big four" would decline to around 20 percent, while that of Japan and China would reach 30 percent apiece.[5] Even for the Indian market the United States has fallen behind China in terms of merchandise exports. The explanation of this relative decline in market share in Asia, the fastest-growing region in the world, is not altogether clear. An overvalued dollar probably accounts for some loss, and the re-establishment of traditional trading ties among Pacific Rim nations also helps account for this remarkable shift. For instance, heavy investments by Korean, Japanese, and Taiwanese businesses have helped them gain market share in leading capital goods sectors in China.

Moreover, a new or revitalized sense of regional identity, sometimes in a thinly disguised effort to displace the United States, also is playing a role in enhanced inter-regional trade and investment. ASEAN itself is a precursor of this new tendency. More recently, China has been very aggressive in promoting regional free trade agreements (FTAs) in the Pacific Rim. China has already concluded an FTA with ASEAN, and South Korea and Japan are trying to join this new regional hub. Japan and South Korea also are negotiating a bilateral FTA. Given the high tariff barriers in the region, a regional FTA which excluded the United States would be a grievous blow to its already sinking market share. Finally, China also recently hosted a meeting of a new economic cooperation group, including Russia and Central Asian countries but excluding the United States, the "Shanghai Cooperation Organization Summit." This is the first multilateral organization of Beijing's making.[6]

High tariff barriers are the third factor important in understanding the huge and growing trade imbalance between the United States and China, and indeed for much of the Asian region. The average applied tariff rates for non-agricultural goods are about three times higher for China than for

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[5] See Ernest Preeg, *Free Trade Agreements Across the Pacific: An Urgent Opportunity for U.S. Manufactured Exports* (Arlington, VA: Manufacturers Alliance/MAPI, November 2005), pp. 3-4.

[6] Frederick Kempe, "Departing Zoellick Looks Back on Pending Business With China," *The Wall Street Journal*, June 27, 2006, p. A10.

Table 1
Exports and Market Share in East Asia
($ billions)

From \ To	Japan	China	South Korea	ASEAN (5)*	East Asian (8)	Market Share Among the Four Exporters**
United States						
2000	$65.3	$16.3	$27.9	$29.3	$138.8	38%
2005	$55.5	$41.9	$27.8	$29.0	$154.2	26%
Percent change	-15%	+157%	0%	-1%	+11%	
Japan						
2000	X	$30.4	$30.1	$47.4	$107.9	30%
2005	X	$80.3	$46.9	$57.2	$184.4	31%
Percent change	X	+164%	+56%	+21%	+71%	
China						
2000	$41.7	X	$11.3	$10.9	$63.9	18%
2005	$84.0	X	$35.1	$37.1	$156.2	26%
Percent change	+101%	X	+211%	+240%	+144%	
South Korea						
2000	$20.5	$18.5	X	$14.1	$53.1	15%
2005	$24.0	$61.9	X	$19.6	$105.5	18%
Percent change	+17%	+235%	X	+39%	+99%	

*Indonesia, Malaysia, Philippines, Thailand, and Vietnam.
**United States, Japan, China, and South Korea.

Sources: U.S. Bureau of the Census for the United States; Japan External Trade Organization (for 2005) and United Nations dataweb (for 2000) for Japan; China's Customs Statistics (for 2005) and China Statistical Yearbook (for 2000) for China; and Korea Customs Service for South Korea

the United States and two-to-three times higher than for the rest of Asia, relative to the United States, as Table 2 shows. Additionally, "bound" tariff rates, which represent ceilings agreed to under World Trade Organization (WTO) commitments, tend to be higher in parts of Asia.[7] If a regional FTA is agreed, the applied rates applicable to the United States could be raised toward the "bound" rate ceilings, further undermining the competitiveness of our exporters. For example, the ASEAN average applied rate could be lifted closer to the "bound" rate of 24.5 percent, especially if the regionalist sentiment was sufficiently strong to protect local investors from competition from non-members, presumably the United States in the lead position. While high tariffs are applied to all exporters equally, they may disproportionately affect more distant suppliers such as those in the United States which are burdened by higher transportation and logistics costs.

Fourth, we at the Alliance have been for many years making the case that China systematically maintains its currency at an undervalued level partially in order to protect domestic firms from competition.[8] Other Asian nations also undervalue their currencies, in part to avoid losing market share to the emerging Chinese manufacturing export powerhouse. We have estimated the extent of undervaluation of the Chinese yuan at around 40 percent. Recent Chinese moves to allow some upward movement in the value of the yuan have been strictly limited and have had no impact in an economic sense. Maintaining an undervalued currency also has the effect, as mentioned earlier, of dampening domestic purchasing power and hence discouraging imports of both consumer and capital goods.

[7] See also, Preeg, *Free Trade Agreements Across the Pacific, op. cit.*, pp. 4-5.

[8] The fullest explanation of the policy is in Ernest Preeg, *The Emerging Chinese Advanced Technology Superstate* (Arlington, VA: Manufacturers Alliance/MAPI and Hudson Institute, 2005), Chapter 8.

Table 2
MFN Tariffs, Applied and Bound
(percent *ad valorem*)

	Non-Agriculture		Chemicals Including Pharmaceuticals		Non-Electrical Machinery and Appliances		Electrical Machinery and Appliances	
	Applied	*Bound*	*Applied*	*Bound*	*Applied*	*Bound*	*Applied*	*Bound*
China	9.5	9.1	6.8	6.7	8.5	8.4	9.0	8.8
Japan	2.5	2.3	2.5	2.0	0.0	0.0	0.2	0.2
South Korea	6.7	10.1	5.8	5.8	6.0	9.5	6.0	9.0
Indonesia	6.7	35.6	5.4	38.1	2.2	34.9	6.0	30.3
Malaysia	9.1	14.9	3.8	11.9	3.7	9.1	8.1	13.8
Philippines	5.8	23.4	3.8	19.6	2.3	19.0	3.7	18.1
Thailand	13.3	24.2	6.7	29.4	8.4	20.2	12.8	18.2
Vietnam	15.7	-	5.1	-	5.4	-	12.8	-
ASEAN (5)*	10.1	24.5	5.0	24.8	4.4	20.8	8.7	20.1
United States	3.3	3.2	3.2	2.9	1.2	1.2	1.9	1.6

*Simple average of all five for applied tariffs; the four except Vietnam for bound tariffs.

Source: World Trade Organization, *World Trade Report 2005*, Appendix tables I, II, and IV

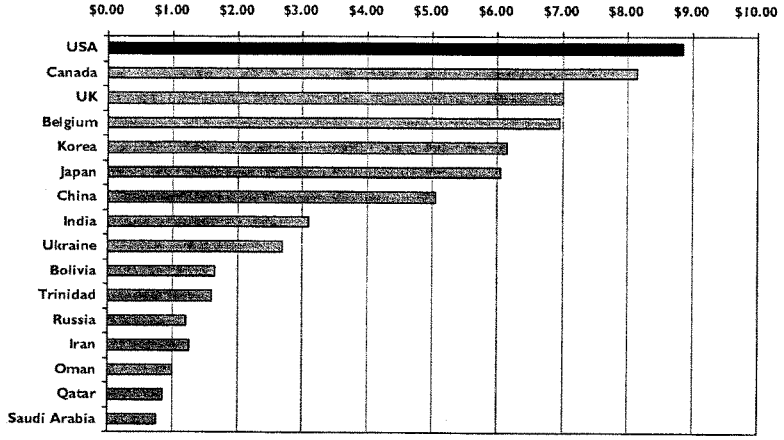
China's currency manipulation deals a double blow to U.S. exporters because, despite some minimal evidence of rising wages and higher raw material costs, it remains a low-cost producer of manufactured goods. In addition to a significantly higher wage structure in the United States (albeit partially offset by higher productivity), the United States imposes much higher levels than its competitors (including China) for what we have labeled "structural costs."[9] In a study completed three years ago, we found that when policy-related costs such as corporate taxes, regulation, tort litigation, health and pension benefits, and energy imports are compared to our nine largest trading partners, over 22 percent is added to the unit labor costs of U.S. firms in relation to competitors. We are currently in the process of updating this study, and preliminary analysis indicates that the cost disadvantage has grown significantly since 2003. For example, as Chart 3 shows, natural gas costs, which are set locally rather than globally, are now higher in the United States than in most parts of the world.

Finally, there are numerous non-tariff barriers to successful penetration of the Chinese market by foreign firms, as well as hidden costs of doing business in that environment which still has an authoritarian and opaque system of governance and little appreciation of truly free markets. It is well known that China has run roughshod over intellectual property rights (IPR), including patents, trademarks, and copyrights, and also of basic property rights. While there is some improvement in these areas since China joined the WTO, and since China learned that better enforcement is conducive to both investment by foreign firms and the development of indigenous technology companies, much work remains to be done. Additionally, a recent study based on a survey of small- and medium-sized enterprises (SMEs), points to further problems: "... lack of regulatory transparency, uneven administration of law and arbitrary application of taxes, notably the value-added tax (VAT), are frequently cited as trade obstacles."[10]

[9] See Jeremy Leonard, *How Structural Costs Imposed on U.S. Manufacturers Harm Workers and Threaten Competitiveness* (Washington, DC: National Association of Manufacturers and Manufacturers Alliance/MAPI, 2003).

[10] See, *The Future Success at Small and Medium Manufacturers: Challenges and Policy Issues* (Washington, DC: National Association of Manufacturers and RSM McGladrey, 2006), p. 21.

Chart 3
Natural Gas Costs Around the World, 2005
($US per million BTUs)



Source: American Chemistry Council

The World Bank has established a database on the costs of doing business around the world. This database is especially useful in giving some measure to the hidden costs which can often be a particular burden to success in countries like China, especially to small- and medium-sized firms that do not have the wherewithal to hire multiple consultants to address the problems in a systematic way. These costs are on top of other difficult issues related to unfamiliarity with the language and business culture of China. The following table highlights some areas where China presents a challenge for businesses, especially smaller foreign firms trying to enter and succeed in that market. The table gives the average results for 155 countries in the database and then shows Chinese trade with the United States as well as Poland and Brazil for comparative purposes.

Table 3
Hidden Costs of Doing Business

	Hiring Costs	Firing Costs	Paying Taxes	Enforcing Contracts		Dealing With Licenses
	(Weeks at Wages)		*(Hours)*	*Days*	*Cost % of Debt*	*(Time Days)*
World Average	16.3	49.3	354.3	394	30.6	209
China	30.0	90.0	584.0	241	25.5	363
United States	8.5	0.0	325.0	546	15.5	70
Poland	25.8	24.9	175.0	980	8.7	322
Brazil	26.8	165.3	2,600.0	250	7.5	460

Source: World Bank, www.doingbusiness.org

Overall, of the 155 economies in the analysis, China ranked 91st in the cost of doing business. It ranked 136th in dealing with licenses, 113th in getting credit, 119th in paying taxes, and 126th in starting a business. By contrast, it ranked 48th in trading across borders and 24th in registering property.

Impact on Small- and Medium-Sized Businesses

A recent survey of SMEs revealed that only 8 percent of them rely on exports for more than 25 percent of their revenues.[11] Moreover, another survey found that over half of SMEs expect to achieve no revenue growth from foreign sales in the future. One-fourth of the respondents agreed that globalization helped them lower costs, but nearly half said it also resulted in lower selling prices.[12] A larger survey done by the National Federation of Independent Business reported only 13 percent of small business owners had foreign sales, although the number rose to 39 percent for small manufacturers. But 61 percent of small manufacturing exporters had less than 5 percent of total revenues from foreign sales.[13] Although more SMEs are now exporting to China and account for about one-third of all U.S. exports to the Middle Kingdom, only about 20,000 firms, or less than 5 percent of the total, account for this activity.[14] There is obviously room for considerable growth.

In fact, many of the problems discussed above, particularly those related to the Chinese market, disproportionately hurt SMEs. For example, non-tariff barriers are much harder for smaller firms with limited resources to overcome. Litigating IPR disputes in the non-transparent Chinese courts can be expensive and not worth the investment for large firms, but prohibitive for smaller firms. Likewise, SMEs do not have the same flexibility as larger firms to offset the disadvantages of an undervalued currency. They do not normally have the know-how or resources to move production around to lower cost areas, invest heavily in productivity-enhancing equipment, conduct sophisticated hedging operations, or diversify their supply chains. Some of the structural costs we have highlighted fall disproportionately on smaller businesses. Regulatory costs, for instance, are more than double the burden for SMEs than for larger firms when measured in terms of cost per employee in manufacturing firms.[15] Health care, tax, and energy costs are also generally more difficult to manage for SMEs as opposed to larger firms.

Recommended U.S. Government Actions

Chinese and, in a broader sense, Asian markets are the fastest growing in the world. For U.S. firms, including SMEs, to prosper in the future, in the sense of successfully competing in their home markets and gaining market share in Asian markets, a number of federal programs and policies should be strengthened and systematically implemented. First, the United States must energetically seek to participate in the growing Asian free trade area movement. A good start has been made in opening FTA negotiations with South Korea, Thailand, and Malaysia. Ultimately, the United States should aim for a TransPacific FTA as initially envisioned by the Asia Pacific Economic Cooperation (APEC) movement. More recently, impetus has passed to the ASEAN plus 3 (China, Japan, South Korea) concept. The United States cannot be left a spectator in anything like ASEAN plus 3. The Doha Round might offer some near-term hope for broad-ranging tariff reduction, but success appears unlikely and the TransPacific negotiations offer more hope in the medium to longer term.

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[11] *Ibid*, p. 39.

[12] RSM McGladrey, *2006 Manufacturing and Wholesale Distribution National Survey* (Minneapolis, MN: RSM McGladrey, 2006), pp. 15-16.

[13] See Lara Chamberlin, "International Trade: NFIB National Small Business Poll" (Washington, DC: NFIB), Vol. 4, Issue 1 (2004).

[14] See "Small and Medium Exporting Companies: Statistical Overview, 2004" (International Trade Administration), www.ita.doc.gov/td/industry/otea/sme_2004/SME_index_2004.htm.

[15] *Future Success of Small and Medium Manufacturers, op. cit.*, pp. 27-28.

Second, on a bilateral basis, the United States needs to be more aggressive in working with China to: end the era of an undervalued yuan and the rampant piracy of IPRs; reduce the non-tariff barriers to trade and the "hidden costs" which are such a problem for SMEs trying to do business there; and gradually move away from the neo-mercantilist domestic policies which discourage domestic consumption and promote an unbalanced, export-led growth model. Former Deputy Secretary Zoellick's dialogue with China through the Joint Commission on Commerce and Trade needs to be energized by his successor to address these bilateral issues in a more urgent fashion. Perhaps other trading powers such as the EU and Japan can be more helpful in working with us to address these issues.

Third, the Executive Branch, with the help of Congress, should address the "structural costs" which add to the competitive disadvantage of U.S. exporters, especially SMEs, in international markets. U.S. corporate taxes and natural gas costs are among the highest in the world,[16] regulatory and tort litigation burdens are especially harmful to the competitiveness of SMEs, and U.S. health care and pension costs, largely borne by companies, are also among the highest in the world. Special urgency is needed to address high natural gas costs, as this energy source serves as both a feedstock to manufacturers and a nearly ubiquitous source of energy, and U.S. prices are now among the highest in the world.

Finally, federal programs at the Small Business Administration (SBA) and the Department of Commerce can be helpful to SMEs that need assistance in joining the ranks of exporters and especially in trying to crack the Chinese market. Survey data shows that a very small proportion (well under 10 percent) of SMEs use government assistance programs, including those at the SBA.[17] I noted earlier the small proportion of SMEs that participate in foreign markets, especially the tough China market. The U.S. Commercial Service at the Department of Commerce does an outstanding job of assisting potential exporters trying to enter new markets. They have offices in 108 nations around the world and are able to assist SMEs in: locating partners and financing, doing market research, solving logistics and licensing problems, navigating customs, and helping with many other issues facing exporters to difficult markets like China. More recently, the Service has been helping SMEs partner with global companies already familiar with the Chinese and other markets. In recent years, the Bush Administration has additional staff working to resolve IPR, market access, and other issues in the Chinese markets. These programs are not widely used and could benefit from greater resources and more visibility.

The U.S. Congress can be helpful in each of these areas, and I would urge members of the Committee to be active on behalf of small and large U.S. firms, alike, as they try to reverse the decline in market share in China and the rest of Asia.

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[16] See Donald Norman, *U.S. Manufacturing and the Evolving Global LNG Market: Prospects for Lower Energy Costs* (Arlington, VA: Manufacturers Alliance/MAPI, April 2006).

[17] *2006 Manufacturing and Wholesale Distribution National Survey, op. cit.*, p. 22.

Testimony

presented to the

Joint Subcommittees

of the Small Business Committee

by

Will Coley

on behalf of the National Cotton Council of America

July 20, 2006

Mr. Chairman, thank you and the members of the subcommittees for inviting me to discuss trade with China. I especially appreciate the assistance provided by Representative Barrow and his staff. My name is Will Coley. I am the managing partner of Savannah Warehouse Services headquartered at the Port of Savannah. Our firm was established to service the growing volume of cotton exports from the southeastern states. I am also a member of the National Cotton Council's 2005-06 Cotton Leadership Class.

The National Cotton Council is the central organization of the United States cotton industry. Its members include producers, ginners, cottonseed handlers, merchants, cooperatives, warehousemen and textile manufacturers. While a majority of the industry is concentrated in 17 cotton-producing states, stretching from the Carolinas to California, the downstream manufacturers of cotton apparel and home furnishings are located in virtually every state.

The industry and its suppliers, together with the cotton product manufacturers, account for more than 440,000 jobs in the U.S. [U.S. Census of Agriculture]. Annual cotton production is valued at approximately $5 billion at the farm gate, the point at which the producer sells [Economic Services, NCC]. In addition to the cotton fiber, cottonseed products are used for livestock feed, and cottonseed oil is used for food products ranging from margarine to salad dressing. While cotton's farm-gate value is significant, a more meaningful measure of cotton's value to the U.S. economy is its retail value. Taken collectively, the annual business revenue generated by cotton and its products in the U.S. economy is estimated to be in excess of $120 billion [Retail Values of U.S. Agricultural Commodities, NCC].

Georgia ranked 3rd in total cotton production in the 2005-06 crop with 2.1 million bales produced, or roughly 10% of the total U.S. crop. The annual farm-gate value of the Georgia crop is estimated to exceed $500 million. The economic contribution of the cotton industry in Georgia is even more significant when accounting for businesses in cotton's processing distribution, and utilization chain. Cotton in Georgia supports almost 54,000 jobs and generates $6 billion in business revenue.

The principal reasons for the resurgence in cotton production in Georgia are the successful eradication of the destructive boll weevil and an effective, stable farm policy enacted by Congress in 2002. Georgia agriculture is highly diversified and producers continue to invest heavily in new technology to remain competitive.

Unfortunately, our domestic textile industry has not fared as well in spite of the investments and major gains in productivity. Cotton farmers are deeply concerned by the loss of our manufacturing base and we are committed to work with manufacturers and legislators to ensure there are policies in place that promote and reward fair competition.

The rapid decline in raw cotton consumption by our domestic mills has created challenges for all cotton farmers but none more than southeastern cotton farmers who must identify new export markets to replace domestic customers. This adjustment places new and added pressure on our infrastructure including surface transportation and port facilities.

In fact, the warehouse I manage was opened at the port of Savannah to serve the growing export demand for cotton produced in the Southeast.

The subject of this hearing is whether China engages in fair trade and abides by her commitments. I will offer the perspectives of the cotton industry on doing business with China, which is a fairly unique perspective.

There are few international trading relationships more complicated or dynamic than that of U.S. cotton and China. The U.S. cotton industry is exporting an ever-increasing amount of cotton fiber to China. In fact, China is not only the number one export customer for U.S. cotton, but is our largest customer overall, will likely remain so for years to come. At the same time, our long-standing customer, the U.S. textile industry, continues to erode financially in the face of competition from textile imports. A recent study by the National Council of Textile Organizations indicates China's share of the U.S. apparel market has grown to 49% and much of that astounding growth has displaced products from Central and South America. China is the most competitive textile and apparel manufacturer in the world.

A few numbers demonstrate the dynamic nature of this trading relationship:

- In 1998, China imposed a quota on cotton imports and imported 332,000 bales of cotton from the world. In 2002, China announced the first tariff-rate quota allocation in keeping with its WTO accession agreement. In that marketing year, China imported 3.1 million bales of cotton from the world overall and 1.8 million bales from the United States.

- As we approach the end of the 2005 marketing year, China has more than 9 million bales in commitments from the U.S. and is expected to import 19 million bales from all sources. It also produced 26 million bales of cotton in marketing year 2005 and exported approximately $105 billion dollars of total textile and apparel products in calendar year 2005, an increase of 87% since 2002. Current USDA projections show China remaining a large importer for the 2006 marketing year with expected purchases of 20 million bales. This represents 45% of total world trade in cotton.

- The growth in China's mill consumption and textile exports should be taken in context with the demise of the U.S. textile industry. In the 1998 crop year, the U.S. still maintained double-digit mill use of cotton. In that year, the U.S. and China combined to register 29 million bales of mill use. Now in 2006, just 8 years removed from 1998, it is projected that China alone will spin about 50 million bales of cotton in its mills - 21 million bales over the combined total of the U.S. and China in 1998. Meanwhile, U.S. mill use has fallen below 6 million bales a year, 40% below the rates that existed throughout the 1990s. I know that this committee is very familiar with the economic situation confronting the U.S. textile industry and the need for appropriate measures to ensure its survival.

The numbers I have recited show very clearly that the United States cotton farmer has a new, very important customer, China. The U.S. cotton industry is currently exporting substantial quantities of cotton to China, and China must continue as an important customer. With its rate of increase in cotton production, cotton mill use and cotton purchasing, China is the dominant force in world cotton.

The short answer to the question -- does China enact barriers to fair trade -- is yes, China does have barriers to fair trade. The cotton industry is also concerned with China's currency policy, the use of tax rebates to encourage exports, and the subsidized or forgiven loans provided to its domestic textile industry. In fairness, however, it is important to consider the steps China has taken to open its markets and the extent to which China's trade rules are still evolving. Despite these improvements, there are still many concerns with specific unfair trade practices. I commend this committee for continuing to focus on these issues.

Market Access – Implementation of the Tariff Rate Quota

After being virtually shut out of the China market in 1998, the U.S. cotton industry welcomed the WTO accession agreement and China's commitment to establish a tariff rate quota of over 3 million bales. While China announced that quota fairly promptly in February 2002, the National Cotton Council raised serious concerns with the way in which China was implementing its commitments. Our primary objection has been China's allocation of a significant portion of the cotton TRQ to the "processing trade." By allocating quota to the processing trade, China is requiring that apparel made from that cotton be re-exported. Essentially, the processing trade category is not true market access as required by the terms of the U.S. - China WTO accession agreement.

As a result of our concerns, the U.S. Trade Representative's Office and USDA's Foreign Agricultural Service (FAS) conducted numerous discussions with China officials in an attempt to get China to modify its implementation of the tariff rate quota (TRQ) for cotton. In 2003, China announced revisions to its regulations that simplified the process and improved matters, but did not eliminate the processing trade distinction.

However, other events in U.S. - China cotton fiber trade have overtaken implementation issues. China has grown to be the largest importer of U.S. cotton in the world; it has increased its import quota above WTO requirements; and it is expected to continue to purchase imports well in

excess of its WTO commitments. This level of trade with China is beneficial to the U.S. cotton industry and relieves the immediacy regarding changes in China's tariff rate quota implementation.

Despite this beneficial trade, the United States and the U.S. cotton industry must remain vigilant and continue to push for reform in the TRQ system. Should internal pressures to purchase foreign cotton subside within China, this private/processing trade distinction could once again become a significant barrier to U.S. exports.

Recently, China has begun applying a variable tariff on imports of cotton over its tariff rate quota. This tariff varies up to 40% depending on the price of cotton, with a smaller tariff applicable if cotton prices are higher. This type of mechanism is a concern and reminds us of the variable levy system that existed under Europe's common agricultural policy. While it is true that China has discretion on the amount of tariff it may impose on imports above its TRQ, that discretion is not unlimited. The tariff has the effect of increasing the price of imported cotton above the prices of domestically produced cotton and synthetic fibers.

Finally, I should note that specific terms of implementation are not the only means by which China can influence imports. The government of China can still exert a significant amount of influence over the availability of credit to importers. By tightening up on credit, China can (and has) quickly caused imports to subside. And, the government can and has attempted to implement costly and unscientific quality testing requirements to slow the flow of imported cotton.

Ability to Enter into Contracts

Initially, there was significant confusion within the U.S. cotton sector concerning the ability of any individual cotton textile mill in China to enter into a contract directly and on their own behalf with a foreign merchant. The accession agreement called for a phase-in of the legal ability of companies to enter into business contracts, but the status of that phase-in and the legal status of individual companies were not very clear.

Overall, however, cotton merchants report that China has expanded the ability of mills to contract and appears to be moving forward with this aspect of their commitments. However, those mills are new to doing business this way. They have a steep learning curve and don't always appreciate the sanctity of their contractual commitments. When the price moves against a mill in China holding a sales contract, U.S. merchants have reported that some mills are unwilling to carry out their contractual commitment. Enforcement of the commitment, then, becomes a serious issue.

Quality Issues

As our cotton exports to China have grown, China's mills have begun to raise quality issues with U.S. cotton. These complaints stem from a number of factors.

First, cotton produced in China is hand-picked and ginned using much older technologies. The result is a different bale of cotton. U.S. cotton has different characteristics as it is machine-

harvested and ginned in modern gins, the result of higher implicit labor and capital costs in the U.S.

As a result of these differences, some U.S. merchants believe Chinese mills often over-penalize U.S. qualities. They seem to have more trouble spinning U.S. cotton than do mills in other parts of the world. We don't think this is because U.S. cotton is of inferior quality, but simply because of differences in the fiber.

Further, all cotton in China, whether produced domestically or imported is still classed manually, which can produce inconsistencies.

In 2003, the China Fiber Inspection Bureau (CFIB) announced an ambitious plan to transform the current manual classification system to an instrument based system. The plan proposed use of High Volume Instrument (HVI) grading of all Chinese cotton bales with primary emphasis on the use of rapid instrumentation testing similar to that used by the U.S. Many details are yet to be resolved but it is a step in the right direction. It is in the best interest of the U.S. if China adopts standards and testing protocols consistent with those we currently use.

Reliable standards are essential for orderly export and marketing of U.S. cotton. Experts from USDA's Agricultural Marketing Service (AMS), FAS, and Agricultural Research Service (ARS) have partnered with Cotton Incorporated and the National Cotton Council to provide technical advice, consultation and assistance to the CFIB. This collaborative effort helps to ensure China grading standards, protocols and parameters are based on sound engineering, scientific and statistical principles consistent with the U.S. Since 2004 the U.S. has hosted several CFIB technical delegations; furthermore U.S. teams have met with the CIFB in Beijing on numerous occasions to further the technical collaboration. Additional discussions are planned with follow up visits by CFIB technologists to the U.S. A Chinese technical delegation recently spent a week in intensive technical discussions with the USDA's AMS, ARS and industry.

Evolving Terms of Trade

Contract disputes are the unfortunate result of new market participants, inconsistent quality classification systems, and volatile markets. U.S. cotton merchants report that there is a critical need in China for an improvement of the rules that govern the terms of trade. Quality complaints are not handled equitably. Contract sanctity is not readily enforced and negative price movements can cause significant cancellations of contracts.

We believe that in order to quickly improve enforceability of contracts, solve quality differences, and improve other critical components of the terms of trade, China should look to internationally recognized bodies that have developed terms of trade over an extended period of time and use their experience. These organizations, such as the International Cotton Association (formerly the Liverpool Cotton Association) could help China revise its outdated and one-sided purchase contracts and help reform the rules governing the settlement of contractual disputes.

The National Cotton Council recently hosted an intern from the China Cotton Association to assist their understanding of our business systems and our terms of trade. The National Cotton

Council also sent an intern to China to work with the China Cotton Association in an effort to continue this exchange of information.

China Textile Safeguards and Bilateral Agreement - Effective Jan 2006-Dec 2008
The China WTO Accession Agreement contained a textile-specific safeguard mechanism that authorizes WTO members to impose import limits on specific categories of textiles and apparel if imports from China disrupt or threaten to disrupt the orderly development of trade. The right to implement safeguards under this provision is shared by all WTO members. Avoiding disruptive shifts in trade patterns is in the interests of all parties.

The Administration's actions regarding textile specific safeguards have been extremely important to the U.S. textile industry.

The temporary textile safeguard mechanism is an appropriate response to disruption that can be caused by significant surges in imports. However, the imposition of safeguards has become controversial with lawsuits trying to prevent the Administration from implementing this provision and with China threatening retaliation of one kind or another should safeguards be imposed.

The efforts by the Administration to make the safeguard process consistent and transparent are commendable. Once a safeguard petition is filed, all interested parties have a chance to file comments and express their views.

The U.S. has implemented a significantly improved import monitoring system, which makes import data available much quicker than was possible under the conventional system. This improved monitoring system quickly showed the import surges the textile industry had predicted. The Committee for the Implementation of Textile Agreements acted appropriately to start an investigation and ultimately impose safeguards on six categories of imports. The new monitoring process, together with a willingness to self-initiate safeguard procedures in appropriate categories, provides a means by which appropriate action can be taken before major market disruption occurs.

Conclusion
China's ever-increasing mill use of cotton is driving its demand well beyond its current TRQ. While the end of the global apparel quota system in January of 2005 opened up the world market for China's apparel producers, the huge export numbers enjoyed by China bring a host of additional challenges for China and the world. In response, importing countries make use of the temporary safeguard provisions available to their textile industries; third-country apparel producers hustle to secure advantageous trade deals with their important markets fearing they will be swept aside by the China apparel juggernaut; and China worries about its economy overheating and must deal with the contradictory goals of low-priced cotton for its mills and higher prices for its cotton producers.

China is the dominant factor in the world cotton and textile markets. It is imperative that the U.S. cotton industry continue to cultivate China as a good customer of our fiber. It is just as

critical that we hold China to its agreements and ensure that as its economy grows and merges into the world economy, our manufacturing base does not become a casualty.

I am certain that this will happen and, despite the bumps in the road, I am convinced our economic relationship with China will normalize.

ATTACHMENT A

Excerpt from National Cotton Council Annual Economic Report – 2006

China Cotton Outlook

China remains the largest cotton producer with a 2005 crop of 26.18 million bales, according to the latest estimates from China's National Bureau of Statistics (Exhibit 107). This year's crop is roughly 2.82 million bales lower than last season's crop. The lower production number is a direct result of reduced acreage as growers responded to weaker prices in the spring of 2005. The Government of China (GOC) made note of the declining trend in cotton production in late 2004 and the early part of 2005 and issued a statement that encouraged farmers to maintain a stable cotton production base. However, cotton farmers, particularly those in the Yellow River and the Yangtze River regions, paid little heed to these government advisories and planted more profitable crops, primarily grain.

In general, Chinese production policy remains unchanged. The Ministry of Agriculture (MOA) encourages steady cotton production based on its Regional Plan for Agricultural Products announced in February 2003. The plan identified three major cotton regions with the greatest growth potential and designated them as primary cotton producing regions. They are: 1.) the Yellow River Basin; 2.) the Yangtze River basin; and 3.) the Northwest region, including Xinjiang. However, MOA's ability to really affect the farmer's planting decision is limited because producers pay little heed to MOA's policy objectives unless they are compensated. Given China's very limited arable land, if forced to choose between subsidizing cotton and grain production, the Government of China is likely to subsidize or otherwise support grain so it can feed the population. Farmers, especially those in the Yellow River region are expected to adjust their crop mix according to which commodity pays best. In fact, the annual swing in cotton area ranged from 11 to 22% over the past five years. Therefore, the Chinese government has its work cut out for itself if it expects to maintain a stable cotton production area.

In a recent press release, the MOA stated that the People's Republic of China will seek to boost 2006 cotton production to meet growing domestic demand. MOA estimated there will be 13.17 million acres (up 3.5%) of cotton planted in 2006, leading to a 27.56 million bale crop (up 5.3%). While consistent with China's goal of satisfying at least 70% of China's domestic demand with Chinese cotton, these projections fall short of previous estimates made by Chinese sources and current market expectations.

Some industry experts believe that China could expand cotton area by as much as 10% over last year or 13.86 million acres of cotton. These expectations are based on relatively higher cotton prices and current plantings of winter wheat. However, accompanying higher cotton prices are higher production costs.

Prices for agricultural inputs are reported to have increased 26.5% in 2004. Increased prices for fertilizer and seeds were said to account for 10% of this total increase. Given the recent rise in petroleum prices and associated products, input costs will likely continue to rise into 2006.

This economic outlook estimates China's 2006 cotton area at 13.40 million acres, an increase of 6.4% from 2005. This expansion takes into account relative crop prices, winter wheat plantings and increased production costs. Assuming trend yields, China would remain the world's largest cotton producer with a projected 2006 crop of 27.92 million bales.

Once again, China accounted for much of the world's 8.10 million bale increase in consumption in the 2005 crop year. China's consumption grew 6.00 million bales, and China now accounts for 38.1% of the world's mill use of cotton. Between 1980 and 1998, China's share of world cotton consumption fluctuated between 22.0 and 25.0%. However, in 1999, China's mill use began surging while the rest of the world grew only slightly. China's share of world cotton use rose for the seventh consecutive year in 2005 as China's share of world textile and apparel exports rose and domestic demand for textiles in China also increased. For 2005, estimates place China's mill use at 44.50 million bales (Exhibit 118).

With China expected to be the big winner in the post-quota environment, it is expected that the trend will continue in the coming years. For the 2006 crop year, China's consumption is projected to approach 46.99 million bales. Growth could be tempered by internal cotton prices that are above those of manmade fibers. In addition, the recent China-U.S. textile agreement could limit growth, but the overall impact on their mill use is expected to be modest.

In 1998 through 2000, China was a net exporter of cotton in an attempt to reduce burdensome stock levels (Exhibit 131). However, their trade position changed to one of a net importer in 2001. With the smaller crop in 2005, China's imports surged as mill consumption continued to grow.

Imports for 2005 are forecast at 16.50 million bales, up 10.11 million bales from the previous year. Origins of Chinese imports have remained relatively unchanged for the past few years, with the United States and Uzbekistan as the top suppliers. With purchases of 5 million bales in the first five months of this marketing year, China is on pace to be the largest consumer of U.S. cotton. It is likely that the U.S. will sell China seven to eight million bales of the 2005 crop.

However, there are still issues with access to China's market. A continuing concern is their allocation of a portion of their quota based on the condition of export of their textile product. In addition, China imposes a variable levy on all imports above the initial quota of 4.00 million bales, in effect raising the cotton price relative to manmade fibers. Based on this variable levy, over-quota cotton for 2006 will be charged between 5.0% and 40.0% duty rate according to CIF value.

With continued demand from their textile sector, China should continue to be a net importer for the foreseeable future. Imports are projected at 16.67 million bales in 2006.