HEARING ON CONSUMER PRODUCTS FROM CHINA: SAFETY, REGULATIONS, AND SUPPLY CHAINS

HEARING

BEFORE THE

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

ONE HUNDRED EIGHTEENTH CONGRESS
SECOND SESSION

FRIDAY, MARCH 1, 2024

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U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

WASHINGTON: 2024

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

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The Commission's full charter and statutory mandate are available online at: https://www.uscc.gov/charter.

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HEARING ON CONSUMER PRODUCTS FROM CHINA: SAFETY, REGULATIONS, AND SUPPLY CHAINS

FRIDAY, MARCH 1, 2024

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Washington, DC

The Commission met in Room 253 of Russell Senate Office Building, Washington, DC and via videoconference at 9:30 a.m., Chairman Robin Cleveland and Commissioner Kimberly T. Glas (Hearing Co-Chairs) presiding.

OPENING STATEMENT OF CHAIRMAN ROBIN CLEVELAND
HEARING CO-CHAIR

CHAIRMAN CLEVELAND: Good morning, and welcome to my colleagues in that giant room.

Before we begin today, I want to take a moment to acknowledge that this is the last day for our Executive Director, Dan Peck. He has served the Commission with distinction and supported the Commission's work on our nation's economic and security interests in China with us for six years. He has a much longer record on this matter in serving in the Army.

It is often a complicated and challenging job managing both 12 Commissioners and a talented staff in the development of research analysis and the production of many papers and our bipartisan annual report.

So I'd like to offer a round of applause as we begin to recognize his important contribution to our work.

So, Dan.

(Applause.)

CHAIRMAN CLEVELAND: Thank you, thank you very much.

Our hearing today supports the part of the Commission's mandate which is to review the safety of products entering our markets from China. We have previously reported on the significant risk for American consumers, retailers, and challenges for federal regulators related to agricultural, pharmaceutical, biotech, and medical products.

With the record increase in global e-commerce, there are rising concerns that dangerous and counterfeit consumer goods with deceptive labeling, lack of federally required warnings, and falsified or no safety testing are being shipped directly from Chinese manufacturers to American consumers.

According to one estimate, a new Chinese product is being uploaded to Amazon every one-fiftieth of a second. So imagine how many are being uploaded on Chinese platforms. U.S. agencies are understandably struggling to keep up with inspections, safeguards, and surveillance.

The problem is real and appears to be exploding. In the past decade, we've seen disturbing instances of unsafe imports from China causing harm to American consumers. From children's toys made with lead and carcinogens to counterfeit cosmetics containing arsenic and human waste.

There are roughly 22 million children under the age of five in this country, with parents who may not know there are health hazards with that Temu $2.00 pacifier, Shein $6.00 cartoon pajamas, or the millions of underpriced educational toys being sold to consumers manufactured in China.

It's not just a potential safety risk of what these companies are selling that causes pause. As our first hearing clarified, dozens of these companies are using advanced tracking and collection tools to violate the privacy of Americans and steal personal information, contacts, location, and other sensitive information, all of which is routinely available to the Chinese Communist Party cells embedded within their management structures.

This is one of several hearings that will help us better understand the policies and practices of Chinese manufacturers, platforms, and the Chinese Communist Party that creates risk for our citizens. And we must also identify appropriate policy tools to safeguard our interests.

Our witnesses today have extraordinary insight and expertise on current U.S. import regs, consumer product safety, and the state of China's manufacturing sector. Six of our ten witnesses have never previously testified, so I welcome them in joining our returning experts.

I want to thank Aubrey, Dan, and Walter for their exceptional work preparing us for today. And I'd like to now hand over the hearing to my co-chair, Commissioner Glas, who is a superb partner in all undertakings.

Kim?

PREPARED STATEMENT OF CHAIRMAN ROBIN CLEVELAND
HEARING CO-CHAIR

Hearing on "Consumer Products from China: Safety, Regulations, and Supply Chains"

March 1, 2024

Opening Statement of Chairman Robin Cleveland

Before we begin today, I want to take a moment to acknowledge that this is the last day for our Executive Director, Dan Peck. He has served the Commission with distinction and supported the Commission's work on our nation's economic and security interests in China since 2018. It is a complicated and often challenging job managing both 12 commissioners and our talented staff in the development of research, analysis and production of many papers and our bipartisan annual report. I would like to offer a round of applause to recognize his important contribution.

Our hearing today supports one part of the Commission's mandate which is to review the safety of products entering our markets from China. We have previously reported on significant risks for American consumers and retailers and challenges for federal regulators related to agricultural, pharmaceutical, biotechnology and medical products. With the record increase in global e-commerce, there are rising concerns that dangerous and counterfeit consumer goods with deceptive labeling, lack of federally required warnings and falsified or no safety testing are being shipped directly from Chinese manufacturers to American consumers. According to one estimate, a new Chinese product is being uploaded to Amazon every one-fiftieth of a second. Imagine how many are being uploaded onto Chinese platforms? US agencies are struggling to keep up with inspections, safeguards and surveillance.

The problem is real and appears to be exploding. In the past decade, we've seen disturbing instances of unsafe imports from China causing harm to American consumers, from children's toys made with lead and carcinogens to counterfeit cosmetics containing arsenic and human waste. There are roughly 22 million children under the age of 5 in this country with parents who may not know if there are health hazards with a Temu $2 pacifier, Shein's $6 cartoon pajamas or the millions of underpriced educational toys manufactured in China. It is not just the potential safety risks of what these companies are selling that causes pause. As our first hearing clarified, dozens of Chinese companies are using advanced tracking and collection tools to violate the privacy rights of Americans and steal personal information, contacts, locations and other sensitive information, all of which is routinely available to the Chinese Communist Party cells embedded within their management structures.

This is one of several hearings that will help us better understand the policies and practices of Chinese manufacturers, e-commerce platforms and the Communist Party that create these risks for our citizens. We must also identify and assess appropriate policy and tools to safeguard our interests.

Our witnesses today have extensive insight and expertise on current U.S. import regulations, consumer product safety, and the state of China's manufacturing sector. Six of our ten witnesses have not previously testified before the Commission, and we welcome them joining returning experts.

I want to thank Aubrey, Dan, and Walter for their exceptional work preparing us for today and I will now hand over to my co-chair and for the hearing, Commissioner Glas.

OPENING STATEMENT OF COMMISSIONER KIMBERLY T. GLAS
HEARING CO-CHAIR

COMMISSIONER GLAS: Thank you. I want to reiterate my thanks to Chairwoman Cleveland. And good morning, everyone.

China remains the United States' largest supplier across a range of consumer products. However, ongoing and emerging trade issues that are challenging the United States' ability to protect the U.S. market and consumers from harm.

The recent Section 301 duties on Chinese imports have fueled efforts by Chinese exporters to avoid or evade tariffs and continue selling to the U.S. consumer marketplace. These tactics range from illegal schemes like transshipment to legitimate channels to avoiding tariffs.

In particular, the de minimis exception allows for the importation of duty-free products to the U.S. market through the international mail system as long as the declared value of these items is less than $800. Recent reports indicate close to four million de minimis shipments are shipped to the United States every day, up 30 percent since last year. This trade is exploding.

Such packages arrive to the U.S. with minimal inspection, minimal scrutiny, and minimal information, challenging the United States' capacity to monitor product safety at our borders and making it impossible to police and have the legal authorities to go after predators who are pedaling these unsafe products.

This flood of small packages not only poses a substantial threat to U.S. manufacturers and workers, but also undermines our consumer safety laws and trade laws, including Section 301.

E-commerce has become a superhighway of the Wild West, rewarding de minimis shipments with duty-free market access, facilitating unsafe products, illegal products, and stealing intellectual property, harming domestic manufacturers, retailers, and the American people.

You will hear real examples ranging from children's toys to pool filters that claim to be made to safety standards, yet fail to fulfill any safety regulations. And all too sadly, some of these stories have ended in severe tragedy.

You will hear from the CPSC about the overwhelming challenges they face in this environment and what the U.S. Government can do about it.

Today's hearing also provides an opportunity to assess China's support for its manufacturing sector and evaluate the challenges China's strategy poses to the U.S. and efforts to de-risk the economic relationship.

Chinese producers continue to grow market share by investing in alternative manufacturing hubs, including Mexico and Vietnam. And while data may indicate these countries are taking market share from China, further examination notes how Chinese manufacturers are key suppliers of component parts to these countries, further solidifying China's dominance in supply chains.

The trade data can't mask the influence China continues to have on the world stage directly and indirectly through other markets.

Before we begin, I'd like to remind you all that the testimonies and transcripts from today's hearing will be posted on our website. I would like to thank the Senate Committee on Commerce, Science, and Transportation for securing this room for our use today, and the Senate recording studio for their assistance in livestreaming this event.

PREPARED STATEMENT OF KIMBERLY T. GLAS
HEARING CO-CHAIR

Hearing on "Consumer Products from China: Safety, Regulations, and Supply Chains"

March 1, 2024

Opening Statement of Commissioner Kimberly T. Glas

Thank you, Chairman Cleveland, and good morning everyone.

China remains the United States' largest supplier across a range of consumer products, however ongoing and emerging issues in trade challenge the United States' ability to protect the U.S. market and consumers from harm.

The recent Section 301 duties on Chinese imports have fueled efforts by Chinese exporters to avoid or evade tariffs and continue selling to U.S. consumers. These tactics range from illegal schemes like transshipment to legitimate channels for avoiding tariffs.

In particular, the *de minimis* exception allows for the importation of duty-free products to the U.S. marketplace through the international mail system as long as the declared value of the items is less than $800. Recent reports indicate close to 4 million *de minimis* shipments enter the United States every day, up 30% since last year. Such packages arrive to the United States with minimal inspection, minimal scrutiny, and minimal information, challenging the United States' capacity to monitor product safety at the border and making it virtually impossible to police and have the legal authorities to go after predators of unsafe products.

This flood of small packages not only poses a substantial threat to U.S. manufacturers and workers but also undermines our consumer safety laws and trade laws, including Section 301. E-Commerce has become a superhighway of the wild west—rewarding de minimis shipments with duty free market access—facilitating unsafe products, illegal products, and stealing intellectual property and harming domestic manufacturers, retailers, and the American people. You will hear real examples ranging from children's toys to pool filters that claim to be made to safety standards yet fail to fulfill any safety regulations. You will hear from the CPSC and the government about their challenges in this environment.

Today's hearing also provides an opportunity to assess China's support for its manufacturing sector and evaluate the challenges China's strategy poses to the United States and U.S. efforts to de-risk the economic relationship. Chinese producers continue to grow marketshare by investing in alternative manufacturing hubs including Mexico and Vietnam. And while data may indicate these countries are taking marketshare from China, further examination notes how Chinese manufacturers are key suppliers of component parts to these countries, further solidifying China's dominance in supply chains. The trade data can't mask the influence China continues to have on the world stage directly and indirectly through other markets.

Before we begin, I would like to remind you all that the testimonies and transcript from today's hearing will be posted on our website. I would like to thank the Senate Committee on Commerce, Science, and Transportation for securing this room for our use today and the Senate Recording Studio for their assistance in livestreaming this event. We'll now begin today's hearing with our first panel.

ADMINISTRATION PANEL INTRODUCTION BY COMMISSIONER KIMBERLY T. GLAS

COMMISSIONER GLAS: We'll now begin today's hearing with our first panel. I'm delighted to introduce our first panelist and our first panel.

The Administration Panel will examine the import surveillance process and consider the ways in which evolving shipping dynamics and online shopping create challenges to ensuring Chinese import quality. We will hear from Mr. James Joholske, Director of the Office of Import Surveillance at the U.S. Consumer Product Safety Commission, who will speak on these issues and related topics.

Thank you so much for your testimony. I was really -- I was very much, I know Commissioner Cleveland too, looking forward to hearing from you today, and thank you so much for coming before the Commission.

I would kindly remind you to keep your remarks to seven minutes, and I will turn it over to you. Thank you.

OPENING STATEMENT OF JAMES JOHOLSKE, DIRECTOR, OFFICE OF IMPORT SURVEILLANCE, U.S. CONSUMER PRODUCT SAFETY COMMISSION

MR. JOHOLSKE: Good morning, Chair Cleveland, Commissioner Glas, and distinguished members of the Commission. Thank you for inviting me to discuss the U.S. Consumer Product Safety Commission's significant role in protecting consumers from health and safety hazards involving imported goods from China.

Before I begin, I should note that these views are those of CPSC staff, and they have not been reviewed or approved by our commission.

CPSC was established in 1972 and is the federal regulatory body charged with protecting the public from unreasonable risks of injuries or death associated with consumer products. We are a very small agency with a very large mission.

We are significantly smaller than other federal protection agencies, with fewer than 600 full-time equivalents and a budget of $152.5 million last fiscal year. We have jurisdiction over thousands of consumer product types, the vast majority of which are imported into the United States.

I joined CPSC's Import -- Office of Import Surveillance when it was created in 2008. And I became its director in 2017. Before that time, I spent eight years in the agency's Office of Compliance and Field Operations, where I worked on enforcement of mandatory requirements for products under CPSC's jurisdiction.

CPSC has a multi-layer process for ensuring the safety of consumer products imported into the United States. CPSC's first objective regarding China, as with other countries with foreign exporters, is to try stop unsafe goods from being produced in the first place.

Our Office of International Programs works to do this by educating and working with foreign regulators and exporters. This includes both virtual and in-person presentations.

They also provide guides on U.S. consumer product safety regulations. The goal is to make product safety information available in a multitude of ways, such that foreign firms, including those in China, are aware and can comply with U.S. consumer product safety laws.

Once the goods leave China, we work to stop any potentially dangerous products from entering the stream of commerce at our ports. CPSC works closely with U.S. Customs and Border Protection to intercept potentially noncompliant, unsafe imported products.

As part of our efforts, CPSC has investigators stationed at the largest ports of entry to work side by side with our counterparts at CBP. As laid out in a 2021 report to Congress, our data shows that more than 80 percent of the shipments that we examined at our ports had China listed as the country of origin.

There are several reasons why we may examine a shipment at the ports, including our history with one or more of the companies in the relevant supply chain and the relative risk of the product being imported.

To prioritize and target high risk shipments, CPSC has developed our own targeting system called the risk assessment methodology, or RAM. RAM leverages a feed of entry data from CBP, which is combined with CPSC data to risk-score shipments under CPSC's jurisdiction.

At our request, CBP stops shipments of interest for physical examination. If after screening, CPSC staff believes a product may not comply with our requirements, port staff collect official samples for further analysis. Technical staff at our laboratory in Rockville, Maryland, then test those samples.

If a violation -- if there is a violation, we send a notice of violation to the responsible manufacturer, distributor, retailer, or importer outlining the specific violations and the need for corrective action.

Corrective action can take several forms, and that is where our Office of Compliance comes in. They work with manufacturers, distributors, retailers, and importers to recall defective products or remove noncompliant products from the marketplace. They can seek civil penalties for certain violations under our primary authorizing statute, the Consumer Product Safety Act. CPSC faces numerous challenges relating to consumer product safety of imported products from China and elsewhere. First and foremost, the sheer volume of imports from China remains overwhelming and difficult to monitor given our resource limitations.

Another challenge has to do with the rise of e-commerce. According to our last comprehensive assessment, almost 60 percent of the volume of imports come to American consumers via e-commerce. This trend is growing every year.

CPSC has little ability to act against third-party sellers who are small manufacturers based overseas. Products including baby mattresses, lithium ion batteries, magnets, baby loungers, and more are left unrecalled because the manufacturer cannot be held responsible.

Moreover, most online marketplaces assert that they do not fall under CPSC's jurisdiction for some or all of their sales. They state that for purposes of consumer safety, they are not retailers, manufacturers, distributors, or importers.

E-commerce has changed consumer purchasing patterns in ways that challenge our enforcement efforts. Consumers continue to shift from purchasing directly from retailers to purchasing directly from manufacturers via e-commerce.

Many of these goods shipped directly to consumers are packaged and sent to us to be under the de minimis value, now set at $800. Shipments of products from China and elsewhere that fall under this value enter our country with minimal requirements and duty-free.

Without the same data we receive for higher value shipments, CPSC cannot utilize its RAM system to know what to be targeted for inspection. De minimis shipments also often enter the U.S. through express courier and international mail facilities, locations where CPSC has very limited coverage.

The bottom line is that we have many goods coming from China about which CPSC receives limited data. That, coupled with the volume of imports and limited staff at major entry points, presents significant challenges to CPSC and our ability to stop dangerous products before they enter the stream of commerce.

Thank you for the opportunity to share my remarks and discuss CPSC's work to keep consumers safe. I would be happy to answer any questions you have.

PREPARED STATEMENT OF JAMES JOHOLSKE, DIRECTOR, OFFICE OF IMPORT SURVEILLANCE, U.S. CONSUMER PRODUCT SAFETY COMMISSION

Testimony of Jim Joholske
Director
Office of Import Surveillance
United States Consumer Product Safety Commission

Submitted to the
U.S.-China Economic and Security Review Commission

Hearing on
Consumer Products from China: Safety, Regulations, and Supply Chains

March 1, 2024, 9:30 AM

Chair Cleveland, Commissioner Glas, and distinguished Members of the Commission, thank you for inviting me to discuss the U.S. Consumer Product Safety Commission's (CPSC or Commission) significant role in protecting consumers from health and safety hazards involving imported goods from China. Before I begin, I should note that these views are those of CPSC staff, and they have not been reviewed or approved by the Commission.

CPSC was established in 1972 and is the federal regulatory body charged with protecting the public from unreasonable risk of injuries or death associated with consumer products. We are a very small agency with a very large mission. We are significantly smaller than other federal consumer protection agencies, with fewer than 600 full-time equivalents and a budget of $152.5 million for the last fiscal year (FY). We have jurisdiction over thousands of consumer product types, the vast majority of which are imported into the United States.

I joined CPSC's Office of Import Surveillance when it was created in 2008, and I became its director in March 2017. Before that time, I spent eight years in the agency's Office of Compliance and Field Operations - or EXC, where I worked on enforcement of mandatory regulations governing products under CPSC's jurisdiction. EXC performs a vital role within the agency, by investigating consumer products that may not comply with mandatory safety regulations or which may contain dangerous defects and, when necessary, pursuing corrective action, including recalls, from responsible parties, such as manufacturers, importers, distributors, or retailers.

Our economy's dependence on imports is well known; for example, in 2022, we imported about 12 percent more than we exported, according to data from the Bureau of Economic Analysis (BEA). We imported more goods of all types from China in 2022 than any other country, according to the U.S. Trade Representative (USTR); China amounted to 16.5 percent as the source of all U.S. goods imports. Therefore, CPSC staff share your interest in examining consumer product safety issues as they relate to China.

A couple things to note, though. First, these figures just cited include trade in all goods; consumer goods (excluding food and automotive) constituted 28 percent of the imports of all goods in 2020, according to BEA, and CPSC has jurisdiction only over those consumer goods that are consumer products under our statutes. Second, in order to best protect the public, CPSC has developed methodologies to target potentially high-risk imports and importers for inspection at ports of entry. These methodologies are designed to adapt to changing marketplace dynamics. While the system does not use country of origin as a factor, historically, the imports identified for examination are overwhelmingly from China. Let me talk about that work in a little more detail.

CPSC Efforts with Consumer Products Manufactured and Imported to the United States

CPSC's first objective regarding China, as with other countries with foreign exporters, is to try to stop unsafe goods from being produced in the first place. Our Office of International Programs, otherwise known as EXIP, works to do this by educating and working with foreign regulators and exporters. This includes both virtual and in person presentations. They also provide guides on U.S. consumer product safety regulations. The goal is to make product safety information available in a multitude of ways such that foreign firms, including those in China, are aware of and can comply with U.S. consumer product safety laws and regulations.

It has been our experience that in China there are three categories of exporting companies. Some are very sophisticated, and both know and comply with our safety regulations. Others do not know the rules but want to be responsible market participants and are thus extremely interested and receptive when we explain the rules.

Unfortunately, however, there are some companies in China that do not know the regulations on making safe products and either do not care to know, are not sophisticated enough to understand them, or are not able to overcome the language barrier to understand them. Oftentimes, the goal of these companies is to just to make as much money as they can before moving on to other products, and innocent Americans are the ones who may suffer.

It is this last category of firms for which enforcement is so difficult. Not only are they not interested or able to follow U.S. safety rules, but as foreign firms, we do not have adequate tools to stop them. We generally are not able to exercise jurisdiction over foreign firms to impose financial consequences.

Once the goods leave China, we work to stop any potentially dangerous products from entering the stream of commerce in the U.S. at our ports. CPSC closely coordinates with U.S. Customs and Border Protection (CBP) to intercept potentially noncompliant, unsafe imported products. As part of our efforts, CPSC has investigators at the largest ports of entry to work side-by-side with our counterparts at CBP.

As laid out in a 2021 report to Congress, our data show more than 80 percent of the shipments we examined at our ports had China listed as their country of origin. There are several reasons why we may examine a shipment at the ports, including our history with one or more of the companies in the relevant supply chain and the relative risk of the products being imported.

To prioritize and target high-risk shipments, CPSC has developed our own targeting system, called Risk Assessment Methodology or RAM. RAM leverages a feed of entry data received from CBP, which is combined with CPSC data to risk-score shipments under CPSC's jurisdiction.

We do not risk assess all shipments under CPSC's jurisdiction in the RAM. Rather, it includes a subset of products within our jurisdiction that have been identified as a priority and that are addressable at import. In FY 2019 and FY 2020, according to CPSC data, more than 60 percent of RAM risk-scored shipments originated in China.

We also have CPSC staff stationed at CBP's Commercial Targeting and Analysis Center (CTAC) to coordinate with CBP and other government agencies to address import safety risks. At CTAC, we implement our national targeting programs using CBP's Automated Targeting System to identify potentially violative shipments.

We look forward to expanding our targeting capabilities with the implementation of our eFiling initiative. After completion of a beta pilot and rulemaking, importers will be required to provide specific data from their certificates of compliance to CPSC and CBP at the time a product is imported. This data showing compliance with CPSC's mandatory requirements will allow the agency to use the information as part of our risk assessment.

At our request, CBP stops shipments of interest for physical examination. If after screening, CPSC staff believes a product may not comply with CPSC requirements, port staff collect official samples for further analysis. Technical staff at our laboratory in Rockville, Maryland, then evaluate and/or test those samples. If there is a violation, we send a notice of violation to the responsible manufacturer, distributor, retailer, and/or importer outlining the specific violation(s) and the need for corrective action. CBP also assists CPSC in using its resources to hold the detained product at the port for the time necessary to conduct the analysis and for seizing and destroying products not in conformity with U.S. safety laws and regulations.

Corrective action can take several forms, and that is where our Office of Compliance comes in. They work with manufacturers, distributors, retailers, and importers to recall defective products, or remove non-compliant products from the marketplace. They also can seek civil penalties for certain violations of our primary authorizing statute, the Consumer Product Safety Act.

However, in all these steps, we are facing significant challenges. Let me discuss those in greater depth.

Challenges Faced by CPSC Related to Products Produced Abroad

CPSC faces numerous challenges related to consumer product safety of imported products from China and elsewhere. First and foremost, the sheer volume of imports from China remains overwhelming and difficult to monitor. Because China exports so many consumer products to the U.S., simply looking at the number of recalls involving products made in China would not provide a fair analysis of their relative safety. But, any way you slice it, consumer goods from China warrant and receive a disproportionate share of CPSC's attention.

Our second challenge is resource related. As mentioned earlier, CPSC is a small agency with a large mission - to keep consumers safe from the unreasonable risk of injury or death from consumer products. A non-exhaustive list of our work includes everything from working at U.S. ports to stop dangerous products from entering our country as discussed above, to enforcing U.S. product safety laws and regulations domestically, to conducting research on new and emerging hazards, to recalling violative and defective products, to engaging in rulemaking to develop and update mandatory safety standards, to communicating public health and product safety information to the public, to companies, and other stakeholders, and much more. Agency staff does incredible work, but the fact of the matter is we receive far less in appropriations than other consumer safety agencies, such as the Federal Trade Commission, which has a budget of $430 million and 1,217 FTE in FY 2023, and the National Highway Transportation Safety Administration, which has a budget of about $1.2 billion and 730 in FY 2023. The appropriations process is ongoing for FY 2024, but we are not expecting a significant increase in funding to do our work.

Currently, we have fewer than 50 investigators stationed at some of the largest ports in the country. Despite our relatively small size, in FY 2023, CPSC port investigators conducted more than 66,000 examinations of consumer products arriving in the United States and stopped approximately 13.7 million noncompliant or hazardous units from reaching consumers. We continue to maximize our efforts with every dollar given to us.

A third challenge that relates to China has to do with the rise of e-commerce. According to our last comprehensive assessment, almost 60 percent of the volume of imports come to American consumers via e-commerce. This trend is growing each year. These are largely from online marketplaces like Amazon, Temu, and Shein, which offer a mix of products that are either sold by third parties or by the websites themselves.

CPSC has little ability to act against third party sellers who are small manufacturers based overseas. Products including baby mattresses, lithium-ion batteries, magnets, baby loungers, and more are left unrecalled because the manufacturer cannot be held responsible. Moreover, most online marketplaces assert that they do not fall under CPSC's jurisdiction for some or all their sales. They state that for the purposes of consumer safety, they are not retailers, manufacturers, distributors, or importers.

CPSC is currently engaged in a lawsuit with Amazon over the Fulfillment by Amazon aspect of its business model, and a decision from the Commission is expected soon. However, that is just one portion of one online marketplace, and it does not address all situations in which online marketplaces provide a platform for third party sellers.

E-commerce also has changed consumer purchasing patterns in ways that challenge our enforcement methods. Consumers continue to shift from purchasing directly from retailers to purchasing directly from manufacturers via ecommerce. Many of these goods shipped directly to consumers are packaged and sent so as to be under the de minimis value, now set at $800. Shipments of products from China and elsewhere that fall under this value enter our country with minimal data requirements and duty free. The value of a shipment is calculated by looking at the aggregate value of the goods purchased by one entity per one day.

The total number of shipments made under this threshold increased about 90 percent between FY 2018 and 2021, according to USTR data. And, of the total number of shipments of goods qualifying for this de minimis exception during that same that period, China accounted for about 60 percent of them, according to a 2022 CBP report.

As referenced above, de minimis shipments enter the U.S. with fewer data requirements than larger commercial shipments. Without the same data as we have on higher value shipments, CPSC cannot utilize its RAM to know what should be targeted for inspection.

Further, as mentioned, CPSC staff are stationed at the ports of entry where larger commercial shipments arrive. De minimis shipments often enter the U.S. through express courier and international mail facilities, locations where CPSC currently has limited coverage.

The bottom line then is that we have many goods coming from China about which CPSC receives limited data. That coupled with the volume of imports and limited staff at major entry points presents significant challenges to CPSC and our ability to stop dangerous products before they enter the stream of commerce.

Thank you for the opportunity to share my remarks and discuss CPSC’s work to keep consumers safe. I would be happy to answer any questions you may have.

ADMINISTRATION PANEL QUESTION AND ANSWER

COMMISSIONER GLAS: Thank you so much. Robin, are you?

CHAIRMAN CLEVELAND: Forget I'm now first because we lost our B commissioners.

As Commissioner Glas said, I really appreciate your appearing today and talking about the challenges you face. I think it's something that as, an about-to-be-grandmother, I have acute concern about in terms of imports of manufactured products from China.

I wonder if you could talk a little bit about, I think you said that platforms view themselves as not falling under various statutes for distribution manufacturing. I think that retailers, I think is what you said.

And I gather that there's a lawsuit that CPSC has underway with regard to accountability. But I'm particularly interested in your certification process. How does that work in practice when it comes to products from China?

Is there any guarantee in your mind that the GCC or CPSC certifications are being complied with, given concerns about de minimis shipping and overall concerns about manufacturing?

That was a long-winded way of saying can you talk a little bit about -- sorry -- CPSC and GCC and the connection to compliance with Chinese manufactured products.

MR. JOHOLSKE: I'd be happy to. Thanks for the question.

Yeah, so under the Consumer Product Safety Improvement Act, which was passed in 2008, there were requirements set in place for products that are subject to a mandatory CPSC requirement to be tested and certified prior to importation or distribution in commerce.

That responsibility to certify for imported products is on the importer. And so there are two -- as Chair Cleveland mentioned -- for general use products, there's a general conformity of certification. And for children's products, there's a children's product certification, which has to be done, that testing must be done an independent third party.

We do, even 15 years after CPSIA was passed, we continue to see violations of our testing and certification requirements. We have a new initiative in place that's called e-filing.

That's going through a rulemaking and beta pilot process right now where we are going to require that information to be filed at import along with other customs data at the time of entry. That will give us a significant -- significantly more data to be able to risk-assess shipments that are coming in.

Right now, the process is when we stop a shipment for examination, we request the certification and the test reports to be able to determine. It's really too late at that point because we've already stopped the shipment. We want that data in advance so that we can use it for risk assessment purposes.

CHAIRMAN CLEVELAND: All right, can I follow up? I wonder what the impact would be if there was statutory or regulatory requirements for two things. First, if it was a facility in which you had confidence in China, perhaps had people positioned onsite, that would be the guarantor for testing. Because I understand there's a lot of falsification in the testing as well.

And then the second requirement or consideration, what would be the consequence of requiring importers, regardless of whether they use de minimis or not, to file the HTS code on all incoming products to the United States?

MR. JOHOLSKE: Yeah, I'll take the second one first. I do think having the HTS code for de minimis shipments is critical. Our jurisdiction when we're looking at data and deciding what falls under our jurisdiction, you know, as opposed to some other agency's jurisdiction is based on, right now based on harmonized tariff schedule classification.

CBP has a test in place right now where they have developed an entry type specifically for de minimis shipments that will allow that information to be filed. We look at leveraging that information in the future.

So I do think that's a critical -- that is a critical piece of data that we need for our risk assessment purposes.

In terms of certification and testing, you know, the way the process is set up right now for children's products is that the testing must be done by a CPSC-accepted laboratory. So there is some, I don't want to call it oversight, but there is some eyes on those firms and those testing companies in terms of being able to meet certain requirements for testing.

CHAIRMAN CLEVELAND: My time's up, but do you have confidence that products that are coming in under de minimis are being tested in CPS labs that, as I said, that you have confidence in? That's just quick yes or no and I'll follow up.

MR. JOHOLSKE: For de minimis, I would say no.

CHAIRMAN CLEVELAND: Thank you.

COMMISSIONER GLAS: Thank you so much, Chairwoman Cleveland. Sorry, I didn't mean to toss that to you, my question. Commissioner Friedberg?

COMMISSIONER FRIEDBERG: Thanks very much. Thank you for being here and for all the work that you're doing.

I had a few questions about the de minimis rule. I'm approaching this from a position of substantial ignorance, so I've learned a lot. Could you just tell us a little bit about why that rule was put in place, when, and what's its legal basis is?

MR. JOHOLSKE: I don't know that I can speak to that in any detail. But you know, my understanding, so the change from $200, which was the previous de minimis value, to $800 happened under the Trade Facilitation and Trade Enforcement Act of 2015.

I think I don't have a lot of background. We weren't a part of, didn't really have an opportunity to provide feedback on that change. So I can't really speak to the reasons behind it. I do believe, though, it was put in place to facilitate trade. with the thought that these smaller shipments, you know, if you increase the trade, the de minimis value, more of these shipments could come in with less data required. That would facilitate them coming into the country easier.

Of course, the downside of that is that government agencies such as CPSC do not have the data that we need on these shipments to be able to risk assess them and decide, you know, what we're interested in in stopping and inspecting.

COMMISSIONER FRIEDBERG: So is it correct that products that come into the United States under this rule are not screened in any way?

MR. JOHOLSKE: No, there is some screening that happens. CBP has at every, at all of these entry points where de minimis value comes in, including international mail facilities, CBP has staff there. You know, when you get to, I'll speak for CPSC, of course we're very limited.

We have less than 50 investigators stationed around the country at ports of entry to monitor all the imports under our jurisdiction. So I mean, you know, we're certainly under-resourced, I think to say the least.

So our challenge of course is, and when our office was created back in 2008, you know, e-commerce was new. And so our -- the way our office has been structured is really looking at larger seaports, border crossings, and airports in terms of where our staffing is.

What we are trying to do as resources become available is pivot and move to some of these e-commerce entry ports like express courier facilities and working at international mail facilities.

COMMISSIONER FRIEDBERG: And how much of what is purchased on e-commerce platforms is coming into the country, if it's made overseas, under the de minimis rule? Do you have any estimate of that?

MR. JOHOLSKE: I would say a -- I don't have data to speak to that specifically. My estimate would be a substantial amount is coming in under the de minimis rule.

COMMISSIONER FRIEDBERG: This may not be a fair questions, so feel free not to answer it. But what would be required to close this loophole? Or let me back up one step.

What would be required on the part of your organization to substantially increase the inspections and screening of products that are coming in under this rule?

MR. JOHOLSKE: Yeah, I think for us first and foremost it's resources. I mean, there's a direct correlation between the number of people that we have at the ports and the number of products that we screen. And obviously if the number of FTEs we received to do this work goes up, we'd be able to do more inspections.

I do think the other aspect of this is, that's critical, is the data portion. And you know, in response to the question from Chair Cleveland, it's, you know, if we can get better data on these de minimis shipments, including a harmonized tariffs code and an entry that's filed, we would then have an opportunity to be able to risk-assess that data and make some decisions on what we want to examine.

Of course, that's all contingent on wherever these shipments are making entry, we have people in place to be able to do the examinations. All the data in the world is great, but if you don't have the opportunity to examine, it's a significant challenge.

COMMISSIONER FRIEDBERG: Thank you very much.

MR. JOHOLSKE: You're welcome.

COMMISSIONER GLAS: I have found your testimony to be incredible. And thank you so much for your service and outlining some of the severe challenges you're facing in a world that's become rapidly changing, accelerated under COVID, with more e-commerce shopping happening. That you probably lose some sleep at night as well as the rest of the CPSC staff with the limited resources you do have and how to deploy those effectively.

You know, I was thinking about this a little bit. Can you walk us through when shipments come into a port, non-de minimis shipments, and you have through your targeted methodologies assessed a risk, do you take one of the baby pacifiers or makeup or whatnot and do you take a sampling of that and then send that off to Rockville to get tested? And take one sampling out of a larger shipment.

I'm just trying to understand process. Because, and I want to counter that process to -- I can't imagine, even if your budget was tripled over night, when you have four million boxes a day, and unwrapping an individual box, you're not quite sure what's in it.

I understand your recommendation on data. How you could even police that, versus opening up a container and looking inside and saying, okay, these are kids' toys?

You know, so can you explain how the international mail, these small little packages, the constraints there, even if you were to resource up, and talk about the testing methodologies that you use.

MR. JOHOLSKE: Yeah, in terms of the testing, what happens, and we have a great set of investigators out at the port that are, you know, that are very knowledgeable on all of our requirements.

And we have screening tools that we have provided them that, for example, can detect the amount of lead in a toy or a children's product, or the amount of phthalates in a children's product. So we do have toys.

So the first, whenever we, based on our risk assessment, we determine that there is a shipment of interest, we work with CBP to have that shipment moved from, you know, a container that's coming off of a ship to an examination warehouse. That way, the entire contents can be unloaded, and our staff has access to everything.

Literally, we start going through boxes and looking at the products and screening them for whatever requirements are applicable. If we detect that there's an issue, we will collect a representative sample from that shipment, send it to our lab in Rockville for confirmatory testing.

Once that testing is done, those results go to our Office of Compliance, who ultimately makes the decision. They look at all the information available and they say it either complies or it doesn't, and then that starts the process of working with the importer or the responsible party.

COMMISSIONER GLAS: If -- I guess a question is the reason I think that we're getting all these small international boxes is because of de minimis. So, and I know CPSC doesn't have a position on this.

But let's say de minimis went away tomorrow. Wouldn't you assume a lot of those packages would then come back via ship or across the border? Would it help in your targeting methodologies?

MR. JOHOLSKE: I think, you know, even if de minimis went away and those shipments were to come, the volume coming in is just overwhelming. You know, I think any way you cut it, any way that it comes into the country.

You know, I think the volume, and the other issue that we deal with is just there are 327 ports of entry in the United States. You know, when you think of border crossings, airports, seaports. So we can't, obviously, with our small, limited budget cover all of those.

So we do the best we can in looking at data, trying to see of the types of products that we're most interested in, where are the entry points. And then we try to make our staffing decisions around them.

COMMISSIONER GLAS: If you had a magic wand in terms of a budgetary request, and this is not official submission to Congress, what would it remotely be?

MR. JOHOLSKE: That's a very tough, tough question. I mean, I think -- I don't know that I'm sort of in a position to give a number. But I would say, you know, something significantly larger than what we have now.

I mean, I think that not only helps and would support my office, you know, the Import Office, but of course our office generates work for other offices within the agency, including our test lab and our office compliance. So when you grow one portion of the agency, you have to grow others as well.

COMMISSIONER GLAS: Right, thank you. There may be a round two here. Commissioner Miller.

COMMISSIONER MILLER: Thank you for your testimony. When we look at the landscape that has developed over the last several years, which involves much more shipments, many more shipments, more and more and more, year after year, coming to the United States, are there particularly bad actors in this?

Are you seeing egregious behavior from certain firms that stands out in comparison to others? You know, we look at the recent trends, Temu, Shein, and others. Are you seeing things getting worse, or is the problem simply getting bigger and harder to comprehend?

MR. JOHOLSKE: I think a little bit of both. I think the problem is certainly getting larger because I think there are new entrants, new companies that are entering the market in one way or the other daily, probably. And from a targeting perspective, we do a couple of things.

Through our national targeting is we do have targeting algorithms that are looking for new entrants into a market.

So for example, if there is a foreign manufacturer that we are seeing for the first time is importing under a tariff code of interest to us, that is a flag for, you know, exam. Because you know, with the thinking that if you're doing it for the first time, there's a risk that you might not do it right.

For repeat violators, we also have national targeting. And this is our most successful targeting program, where we identify suppliers and manufacturers that have exported in the past products that are noncompliant and then we will target them. And regardless of who the importer is.

So I think we continue to see repeat violators. We focus on them as much as we can. But then I think to your point, there are numerous new entrants into the market daily.

COMMISSIONER MILLER: A similar follow-up. Some of my fellow commissioner have been pushing at the idea about what would a world look like without de minimis. There's obviously a lot of issues to deal with. The problem wouldn't go away. The manpower shortage wouldn't go away.

But are there secondary consequences that you might help us think through in terms of transshipment issues. Would this change, if we're looking at the problem being principally a problem coming out of China or Hong Kong, would this change, transshipment motives, would this change the nature of the problem, even if it didn't change the scope or the breadth of the problem?

MR. JOHOLSKE: I think it could. So CPSC does not have any jurisdiction over transshipment issues. I know CBP looks at that very closely. So it's not an area that we're really involved in, so I don't know what the impact on the transshipment issue would be.

I do think there are likely, you know, issues if de minimis were to go away. I mean, I'm not advocating for that. I think, you know, when de minimis went from $200 to $800, it changed the landscape significantly.

I think along with that, though, we had a natural trend of folks shopping online and e-commerce expanding. I think you had COVID, which you know, certainly contributed to that a while a lot as well.

So you know, I don't -- and again, I'm not advocating necessarily to roll back de minimis to -- to $200 or get rid of it, but I do think it is critically important that there needs to be sufficient data to be able to risk assess these shipments.

And I think the entities that are involved in these transactions, there needs to be a way that they are held accountable for what they're bringing into the U.S.

COMMISSIONER MILLER: Thank you.

COMMISSIONER GLAS: Thank you. Commissioner Price.

VICE CHAIR PRICE: Good morning and thank you very, very much for coming to speak to us today. This is very helpful.

I'm going to go back to some of the line of questioning that Commissioner Glas had that I know you don't want to answer, but we're going to see what else we can figure out here, having to do with what kind of resources would be really needed to do the job that you have in front of you.

So short of not wanting to give us specific numbers, you have 50 inspectors. You said that there are 700 -- 373 border crossings?

MR. JOHOLSKE: 327 I believe is the last number I heard.

VICE CHAIR PRICE: Oh, 327 border crossings. What would you need in terms of people power?

MR. JOHOLSKE: I would not, excuse me, advocate that we need someone at each of the 327 ports. Again, we look closely at the data of products that are coming in by HTS code. And look to see, you know, what that volume is and what our interests are.

I certainly think there are ports that we are not at now that we likely should be at. There are ports where we have -- we have some, for example, we have some ports right now where we have a single CPSC investigator.

Now, obviously, if that investigator is out sick or on leave, we have a gap in our enforcement at that particular port. So having more than one person at a port is I think also a critical thing to look at.

Where we have really focused our attention more recently has been on the e-commerce side and the de minimis side. And trying to expand our footprints to the large express courier hubs so that we can have staff there along with CBP. And looking at how to staff international mail facilities in a way that makes sense.

You know, you also have to think about risk in terms of size of shipments. You know, a 40-foot container that has maybe 10,000 products, there's more risk there than a single package that's coming into an international mail facility that has one product.

So there's a little bit of give and take there as well in terms of trying to decide the best place to put staff.

VICE CHAIR PRICE: That's helpful. One of my questions was going to be how do you triage it. So are we talking tripling the number, quadrupling the number, something in that range?

MR. JOHOLSKE: I think I would take any additional resources that can come our way. And I guarantee we would put them to good use.

VICE CHAIR PRICE: Good government employee. Is there a better procedure? This is the procedure that you were handed, that you were given. If you were creating the procedure now from scratch, is there a different way you might do it, or does it come back to that triage issue?

MR. JOHOLSKE: So I do think the requirements that are in place now to require testing and certification are incredibly important. Because that does give us some assurance. Now, not to say that's a perfect process by any stretch of the imagination.

Because we do find issues with testing in certificates where the testing may not actually represent the product that's being imported.

You know, a manufacturer may give a test lab a number of samples to look at, but the actual products that are being imported are something different made with different materials. So it's not a perfect process, but I think it's a huge step in the right direction.

I think there's no substitute, though, for having boots on the ground and doing examinations and looking at products that are coming in. Not only for existing regulations, but looking at emerging hazards and things like that.

So I do think it's critical to have that, which is not always an easy and clean process, but literally opening up boxes and examining products.

VICE CHAIR PRICE: Thank you, I'll leave it there.

COMMISSIONER GLAS: Thank you. Commissioner Schriver.

COMMISSIONER SCHRIVER: Good morning. Thank you very much for your testimony, and thanks for your continuing service in this important area.

I wanted to ask questions about resources. I think we've covered that pretty thoroughly. So let me ask a question about the partner country in this case, China. Commissioner Miller asked about bad actors who may turn up time and again.

I'm curious about China as a problem not simply because of the volume, and I take it -- I take the point, the challenge is mostly defined by the fact that there are huge quantities, huge percentage of our global imports, etc.

But isn't it also true that China's a problem because of their poor regulatory record internally in China at these place of manufacturing?

This is a country that can exert incredible control. I mean, if any of these products had an anti-Xi Jinping slogan on it, you can be sure they would go into the factory and shut things down. So I'm curious, you know, what is the engagement like with China?

Do your interagency partners support you in conveying important points about what we'd like to see improve in their regulatory and safety environment? And where does China rank, not as a matter of volume globally, but do we have other countries that consistently are exporting to the United States with proper regulation in terms of the manufacturing that's taking place in their own sovereign territory?

MR. JOHOLSKE: Yeah, in terms of China, in talking with our International Programs Office, I think we consider the relationship that we have with our Chinese counterparts to be positive. I think they are open and allow us to conduct trainings either virtually or in country for Chinese suppliers and manufacturers.

There is a, actually just note that there is a trilateral summit next month on consumer -- on product safety involving the Chinese, the Europeans, and U.S. And the chair of our agency is going to be attending that.

So I do think generally speaking that the dialog seems to be positive and cooperative. I do think, you know, in terms of products under our jurisdiction that are being imported into the U.S., China is by far the largest.

Just a couple of stats to give you. Eighty percent of the products that we examine generally are country of origin of China. Just last fiscal year, nearly 80 percent of the shipments that we examined where we found a violation had a country of origin of China.

So you know, I think some of that is volume. The volume from China is tremendous, and that is where -- that's what's leading us to focus our resources.

COMMISSIONER SCHRIVER: Great, thank you. As I said, most of my other questions had to do with resources and how you would allocate additional resources. I think that's been covered. I'll yield back the rest of my time.

Thank you.

COMMISSIONER GLAS: Thank you. Commissioner Sims?

COMMISSIONER SIMS: Thanks for your testimony. I do want to lean in a little bit more on the resource question and maybe frame it in a different way.

You know, any time an appropriator's making a decision about where money's going to go, they're obviously having to balance a lot of factors there. And one of those is of course, and especially in this case, consumer safety. But I think there's also a national security component to it.

And so as you look at the amount of resources that you're receiving, we've heard loud and clear we need more. There's no question about that. But would you categorize the risk to U.S. consumers, or the national security risk to the United States as disproportionate to the amount of resources that you are receiving?

In other words, would you look an appropriator in the eye and say if you don't give me money, you are putting American citizens at significant risk?

MR. JOHOLSKE: I think that's an accurate statement. I mean, I would just note our FY 24 budget request is $212.6 million, so that may be a starting point that we could look at, 152 million in FY 23. So that's, that would be I think an increase that would certainly give us more.

I think to answer your question, I think I could look an appropriator in the eye and say absolutely, yes. The resource level where we are at now and the staff, and I'll speak for my office, the Office of Import Surveillance, we do not have enough resources to adequately address the risks that are coming in related to imported products.

And again, China is by far the largest exporter to the U.S. of products under our jurisdiction.

COMMISSIONER SIMS: So as you're thinking about how you'd deploy the resources that you do have, you mentioned I think 80 percent of the issues that you all see are country of origin being China.

So if we look at, let's just take maybe like the top five importers for the United States of consumer goods, be they China, Mexico, Canada, Japan, Germany, if I look at that list, one of those things stands out as a significantly greater problem than the others.

Do you treat all of those things the same? Or do you have as a part of your decision making process of what's most likely to get inspected? Is one of those, you know, China, weighted far more heavily than the others?

MR. JOHOLSKE: Yeah, I think in terms of targeting, we don't specifically target based on country of origin. We're looking at risk factors, such as where -- who in the supply chain, regardless of country, you know, are there new companies involved, repeat violators, products of interest. So we tend to focus on things like that.

That naturally, in the environment that we're in now, is China. So I would just say from a risk assessment perspective, I don't think we need to target China because the risk is leading us into that direction as we look at other risk factors.

COMMISSIONER SIMS: So there wouldn't be any, I guess, enhanced ability to screen out where 80 percent of the issues are coming from if we weighted China more heavily in our --

MR. JOHOLSKE: No, it's going to all lead us -- the path is going to lead us back there.

COMMISSIONER SIMS: Got it. So you mentioned an algorithm that you all use. I'm sure there's technology components to what you do in terms of figuring out what's going to be screened. How do you foresee technologies like artificial intelligence or whatever they may be impacting things going forward in terms of your ability to correctly identify?

MR. JOHOLSKE: Yeah, that is something that we're looking at across the agency in a number of different contexts. How AI and machine learning can benefit us. And certainly, that is something we would like to move towards in our risk assessment of imported products as well.

COMMISSIONER SIMS: It seems like to me, as I'm thinking about it -- I'm certainly no expert. I've learned a lot from your testimony, so thank you. That there's probably something to be said for a more whole-of-government approach to the issues that you all are addressing in the consumer product perspective, other agencies are addressing in other areas as well.

Is there any coordination across agencies that you're aware of from a technology perspective to address that?

MR. JOHOLSKE: Some. I would say each agency is in some respects figuring it out on its own. Because of, you know, jurisdictional issues and statutory requirements and things like that. I will say we work and have a great partner in Customs and Border Protection.

We -- there is a commercial targeting and analysis center that CBP has stood up where we have a staff person co-located. CBP, we work with CBP to target shipments coming in using their targeting system. So that's another layer of targeting that we have. We have our own internal system. We have CBP's system that we utilize as well.

Plus we have local operations and blitzes that happen at the port level. So we try to take a layered approach. There is a lot of conversation about the future in terms of technology, particularly around Customs and Border Protection's automated commercial environment and the next generation of that.

So I do think that there is -- certainly agencies are trying to figure it out on their own. And then I do think there's somewhat of an enterprise approach going on as well.

COMMISSIONER SIMS: Thank you.

MR. JOHOLSKE: You're welcome.

COMMISSIONER GLAS: Commissioner Wessel?

COMMISSIONER WESSEL: Thank you, sir, for your being here today. Thank you for your service. Excuse me, I also want to recognize we have two new Commissioners to my right, and thank you for being here today. Appreciate your being new members to the crowd.

I got a lot of questions, so there may be, if there are two rounds, the ability to ask them in another round. Let me ask some questions which you can help me on.

In the food area, when there is a shipment denied entry, it's returned to the shipper. And we've had port shopping in the past. What happens with shipments that CPSC may say should not be entering the country? Are they confiscated, or are they destroyed, or are they returned?

MR. JOHOLSKE: Generally speaking, we work with Customs to have those seized and destroyed.

COMMISSIONER WESSEL: Seized and destroyed, generally, but generally.

MR. JOHOLSKE: There are exceptions. There are times when we feel that the violation is perhaps an administrative violation and as we have examined the product, we have not found a substantive issue that we think, you know, like a lead issue or a phthalates or a small parts or something like that.

So that there are instances when those shipments would get returned exported out of the U.S.

COMMISSIONER WESSEL: Okay, but again, as you just said, that is not where there's a risk to the ultimate consumer if they were to reenter the market.

MR. JOHOLSKE: That -- yes.

COMMISSIONER WESSEL: Thank you. Second, you've talked about HTS codes, which go down to the ten-digit level. Unfortunately I have more knowledge there than I'd like. But those I think are not necessarily sufficient to gain real visibility into the products that are coming in. I don't think there's an HTS code for baby pacifiers.

So how in terms of your RAM method are you doing the screening? You know, I don't know whether that, again, a pacifier is there, you know, some other non-child-related use of a product that would come under the ten-digit code that you wouldn't be concerned with?

MR. JOHOLSKE: Yeah, targeting based on the HTS is absolutely a challenge. As you said, even at the ten-digit level. It does not drill down to the specific type of product.

We do the best we can with the information that we had. We have worked with the International Trade Commission to put in place at the ten-digit level some codes that help us better identify products.

For example, years ago there was only one code for toys. We worked with them to break that out into three codes based on age grade -- based on the intended age of the user of the product, which aligns to our regulatory requirements.

So that's just one example.

COMMISSIONER WESSEL: Right. As I recall, the HTS reviews, is it every five years?

MR. JOHOLSKE: Actually there are updates every six months. I think there is a more of an international review every five years.

COMMISSIONER WESSEL: Right, okay, okay, that's what I'm referring to. Okay. You mentioned first shipper review. But what ability is there to cloak shipments under existing shippers that, under your RAM model, might not, you know, be subject to full scrutiny? I say that based on Commissioner Sims' questions about AI.

If I'm China looking at what products I want to send in, and I'm getting data as to which shippers might be subject to enhanced investigation, I'm going to shift those shipments to make sure that they're getting in. What counter methodologies are there to ensure that we're not facing enhanced risks?

MR. JOHOLSKE: It's a huge challenge, because one of the issues that we do see is, you know, we've identified a bad actor in some way. And that bad actor then essentially stops import -- or exporting or importing, and then pops up as another, you know, as another entity.
We try through some of our targeting currently to be able to identify those first-time --

COMMISSIONER WESSEL: The first shippers.

MR. JOHOLSKE: First shippers, to be able to look at them. But just with the resources that we have available, we can't get them all.

COMMISSIONER WESSEL: Right, okay. I see my time has expired. If there's another round. Thank you.

COMMISSIONER GLAS: I think we're almost up on time. I'm going to pass this off to Chairwoman Cleveland.

CHAIRMAN CLEVELAND: Thank you. I think Mr. Joholske, we could keep you here for hours, as our questions are evident. I'm hopeful that you'll be able to answer questions for the record, because I think there are details that we don't understand that are important to our annual report.

I want to note, as a former director at OMB, that your care and precision on your answering the resource question I think probably has kept you out of a lot of hot water. I think it's very difficult for us to assess your agency versus a defense agency, so I appreciated how Commissioner Sims framed the issue.

I think we have not covered accountability sufficiently today. And I know that Commissioner Glas and I are both concerned about what happens if you identify a necessary recall. Is that voluntary? If you identify a repeat bad actor? Where is there accountability in this process?

And I think this is the last question, given the time, but as I said, I hope you'll answer questions for the record.

MR. JOHOLSKE: Yeah, accountability is a big issue, especially with foreign exporters where there's not a U.S. presence here. We are very challenged by that in trying to work with, negotiate with foreign companies that we don't have jurisdiction over, basically.

And the agency, and I know our Office of Compliance does the best that they can. There are times when there will be products that are -- that we are not able to negotiate a recall with the responsible party.

That often leads to the agency issuing a product safety notice, a unilateral notice notifying the public of what the risks are with a particular product. Sometimes that's the best we can do.

And certainly happy to answer questions for the record.

CHAIRMAN CLEVELAND: That would be great. So I think with that, Commissioner Glas, that wraps up this panel?

COMMISSIONER GLAS: That is correct.

CHAIRMAN CLEVELAND: Okay.

COMMISSIONER GLAS: And we'll take a short break for about the next, I would say about ten minutes. So we will be back.

Thank you so much for you testimony.

MR. JOHOLSKE: Thank you very much.

CHAIRMAN CLEVELAND: Very much appreciated.

(Whereupon, the above-entitled matter went off the record at 10:30 a.m. and resumed at 10:41 a.m.)

PANEL I INTRODUCTION BY CHAIRMAN ROBIN CLEVELAND

CHAIRMAN CLEVELAND: Thank you. So our next panel will assess the safety and quality of consumer products from China and the extent to which consumers and firms are able to detect and respond to risks presented by unsafe, counterfeit, and poor quality imports.

We'll start with Ms. Teresa Murray, Director of the Consumer Watchdog program for the U.S. Public Interest Research Group. Ms. Murray's testimony will address the risks of unsafe and poor quality toys and children's products from China.

Next, we'll hear from Mr. Daniel Shapiro, Senior Vice President of Brand Relationships and Strategic Partnerships at Red Points. Mr. Shapiro will examine China's role in the U.S. counterfeit goods market and discuss the relationship between online shopping, counterfeit goods and risks to U.S. consumers.

Finally, we'll hear from Mr. Dan Harris, lawyer and founder of the International Law Firm Harris-Sliwoski. Mr. Harris will assess U.S. firms' ability to conduct due diligence on Chinese manufacturers, as well as the challenges U.S. firms face when working with Chinese manufacturers of unsafe or defective goods.

I thank you all for your testimony. The Commission is looking forward to your remarks and we'll begin with Ms. Murray.

OPENING STATEMENT OF TERESA MURRAY, DIRECTOR OF THE CONSUMER WATCHDOG PROGRAM, U.S.-PUBLIC INTEREST RESEARCH GROUP

MS. MURRAY: Good morning. I'm Teresa Murray. I'm Director of the Consumer Watchdog program at U.S. Public Interest Research Group. We are a non-partisan, non-profit organization and we focus on problems that affect people's safety or their health or financial well-being.

Now for 40 of our 50 years, we've put out an annual toy safety report and we do that right before the holidays. Our research has found that, in general, toys are much safer today than they were decades ago because of the Consumer Product Safety Improvement Act in 2008, plus efforts from regulators, toy manufacturers, distributors, consumer advocates, and more awareness from parents, frankly.

However, every year at U.S. PIRG we find toys that are posing some kind of safety threat. And of course, every year the Consumer Product Safety Commission and U.S. Customs and Border Protection, they find dangerous toys either that are already on the market, on store shelves, or that are in people's homes, or they're attempting to come across the border. That's the good part.

You know, frankly, dangerous toys invade our homes because too many domestic and international manufacturers, importers, distributors, and retailers either they don't know about safety standards or they just don't care. We find that the biggest problems in the marketplace today are imported toys, counterfeit toys, and toys that have already been recalled, but remain on sale for purchase. Now toys that have already been recalled, but remain available for purchase, they're a particular problem. I brought a couple of my friends that I bought online after they were recalled. So toys intended for children 12 and under must be third-party tested and be certified as compliant with the federal toy safety standards enacted by Congress.

Dangerous products are usually identified either by the company, by consumers who file complaints after they've bought something, by the CPSC, or from reports filed by hospitals, fire departments, and so forth. About 79 percent of toys sold in the U.S. and Europe are manufactured in China. That's actually doubled the percentage of imports from China to the United States for all types of consumer products. But let's talk about toy recalls. So in 2023, the CPSC recalled 23 toys. Of those, 19 were manufactured in China; of those, 12 posed a choking hazard, and 3 violated toxic standards.

Now you might be saying, 23 toys recalled that were found to be dangerous, that's not that much. Well, it is. Unfortunately, those 23 toys are implicated in 68 injuries and 3 deaths of children so far. But there are actually a lot more dangerous toys out there. First, the recalled toys represent only a fraction of what authorities actually believe is dangerous. The CPSC found hundreds of toys last year that violated safety standards. Of the 2164 notices of violations from the CPSC from January through October of last year, nearly 1600 involved products made in China. Most of those were toys or other children's products. The notices usually involve imports. Some of them are caught at the port. Sometimes, the companies are told just to stop selling the product or correct future production or change the labeling, something like that. Sometimes they're told to recall them. So of the 2164 notices of violation, 336 were recommended for recall, but only a handful, including two toys, were actually recalled as of December 31st.

Second, even with toys that are identified as dangerous, and that the CPSC would like to recall them, they can't do that without taking legal action. And because of that, toys and other dangerous products often take months or years to get off the market.

Here are two examples of this involving toys manufactured in China that were recalled last year. So first of all, we have our Calico Critters. In 2018, a toddler's death was linked to choking on part of this toy. There are other incidents, too. Five years later, it took five years, in March of 2023, the company recalled 3.2 million of these toys.

And then we have the Robo Alive Shark bath toy. Starting in 2018, parents filed complaints with the CPSC. This thing is really hard and a child would fall on it and there were a number of incidents reported where children had cuts in their groin, had internal bleeding, all kinds of awful stuff. And five years later, it took five years, the company recalled 7.5 million of these guys.

So besides announcing recalls and issue violation notices, the CPSC last year issued 38 warnings for products that it wants to get recalled, but the companies either won't cooperate or they won't respond. Twelve of those were for toys, eight were for infant sleep products. Of the 38, 35 were imported, 20 were manufactured in China.

In addition, the CPSC can't recall toys or any other products that are counterfeit. Counterfeit knockoff toys, they're a threat because they a lot of times don't comply with U.S. safety standards. Many of them are low quality. They can break easily, cause injuries, and sometimes they contain toxics which we can't see.

In FY23, the CPSC in collaboration with Customs, seized more than 1.1 million toys that were dangerous or illegal. Meanwhile, Customs in FY22 says it seized 101 shipments of toys from China for copyright infringement which means they were counterfeit. Now a single shipment can contain hundreds or even thousands of the same item. So 101 shipments could actually mean tens of thousands or hundreds of thousands of toys.

Now the CPSC's Office of Import Surveillance has enough staffing only to cover 6 percent of our 327 ports of entry. So part of the problem here is, and I know one of my colleagues is going to address this, is people do a lot more shopping online these days, and so that means a greater risk of buying something that either doesn't meet standards or it's already been recalled. A lot of the online market places are international, so what you get in the mail doesn't even get inspected. And if it's a U.S. marketplace, they may be selling items from other countries, but you don't know because the product is shipped from an international re-shipper warehoused in the United States.

So we have a few recommendations that I outlined in my written testimony. To hit on a few of them, we would like to see several things as far as congressional action that would improve toy safety. Support the Sunshine and Product Safety Act to allow the CPSC to warn consumers more quickly. Congress or the courts should clarify that the 1996 Communications Decency Act doesn't insulate online platforms from responsibility for products sold illegally. And also, Customs needs more resources. CPSC needs more resources.

We need to have the CAP Act passed that would increase civil penalties. We need to pass the Ban Water Beads Act. And I mean the bottom line is here about 150,000 children 14 or under are treated in emergency rooms every single year for toy-related injuries. And we know that parents, caregivers, families, and shoppers of all types generally assume that because something is for sale, you know, it must be safe, but of course, that's often tragically wrong.

Thank you for inviting us.

PREPARED STATEMENT OF TERESA MURRAY, DIRECTOR OF THE CONSUMER WATCHDOG PROGRAM, U.S.-PUBLIC INTEREST RESEARCH GROUP

Testimony before the U.S.-China Economic and Security Review Commission "Consumer Products from China: Safety, Regulations, and Supply Chains"

Friday, March 1, 2024
By Teresa Murray
Consumer Watchdog Director, U.S. Public Interest Research Group

Good morning. I'm Teresa Murray, director of the Consumer Watchdog program at U.S. Public Interest Research Group. We are a non-partisan, non-profit organization founded more than 50 years ago. We focus on standing up to special interests involving problems that affect the public's health, safety and financial well-being. For 40 of those years, we've published an annual toy safety report that identifies dangers in the children's marketplace. We generally publish in November, ahead of the holidays and the busiest time for toy shopping.

Our research has found that, in general, toys such as stuffed animals and games are safer in many ways today than decades ago, because of the Consumer Product Safety Improvement Act adopted in 2008, plus efforts by regulators, toy manufacturers and distributors, consumer advocates including PIRG and more awareness by parents and caregivers.

However, every year we at PIRG identify toys that pose some kind of threat, in violation of safety standards. In recent years, our work has led to dangerous toys being recalled or removed from the marketplace, as in fidget spinners sold by Target that we tested in 2017 and found contained

330 times the amount of lead allowed for children's products, and Calico Critters that we wrote about in 2020 that posed a choking hazard and were recalled in 2023.

And of course, every year, the Consumer Product Safety Commission (CPSC) and U.S. Customs and Border Protection (CBP) find dangerous toys, either that are on the market, already in people's homes or attempting to come across the border.

Frankly, dangerous toys invade our homes because too many domestic and international manufacturers, importers, distributors and retailers either don't know or don't care about safety standards. We find the biggest problems in the marketplace are:

- Imported toys
- Counterfeit toys that may have been produced domestically or internationally or
- Toys that have already been recalled but remain available for purchase.

The expectations for toys are high. "All children's toys manufactured or imported on or after February 28, 2018, must be tested and certified to ASTM F963-17 (ASTM) International was formerly known as American Society for Testing and Materials," the CPSC says.

Further, "all toys intended for use by children 12 years of age and under must be third-party tested and be certified in a Children's Product Certificate as compliant to the federal toy safety standard enacted by Congress," the CPSC says. The laboratory must be one accepted by the CPSC. The standards vary depending on the type of toy and the age group it's marketed to.

Dangerous products are usually identified in one of three ways:

- The company identifies a defect through its own testing or monitoring after a product is offered for sale.

- Consumers complain to the company.
- CPSC staffers do testing or secret shopping, or investigate incidents reported by consumers, doctors, fire officials or others on SaferProducts.gov. CPSC staff also review death certificates and other records to spot possible problems.

Pivot over to where our toys are coming from. From January through September of 2023, China manufactured 79% of the toys sold in the United States and Europe, according to a Reuters report in January 2024 using data from S&P Global Market Intelligence's trade data service Panjiva. That's double the percentage of imports from China to the United States for all types of consumer goods.

Toy recalls

In 2023, the CPSC recalled 23 toys. Of those, 19 were manufactured in China. Of those, 12 posed a choking hazard and three violated toxics standards such as lead and phthalates.

Now, you might be saying, only 23 toys were found to be dangerous in 2023? That's not much. There are two big caveats to that:

Recalled toys represent a fraction of what authorities believe is dangerous

First, the CPSC actually found hundreds of toys that violated safety standards last year. Of the 2,164 Notices of Violation issued by the CPSC from January through October (the latest data available,) 1,572 involved products made in China. Most of those were toys or other children's products. These notices usually involve imports; some are caught at the port.

Of the 2,164 Notices of Violation, 336 were recommended for recall, generally because some of the items had already been sold and had a serious issue. But only a handful were recalled as of Dec. 31, 2023.

Examples of some of the violative toys are a musical tree toy and a toy truck with small parts that could choke a young child, and a piggy bank with excessive lead in the paint. We believe that only two of the companies that were sent notices to recall toys (both are fidget magnets) had recalled them as of Dec. 31, 2023.

Here are examples of two products manufactured in China that were recalled last year after the company received notice of violation. One was a toy; the other wasn't:

- **High-Powered Magnetic Balls**
  This 216-piece set of 5 mm magnets "do not comply with the requirements of the mandatory federal magnet regulation because the sets contain one or more magnets that fit within CPSC's small parts cylinder, and the magnets are stronger than permitted," the CPSC said.
  The China-based company was sent a Notice of Violation on Sept. 22, 2023. When high-powered magnets are swallowed, the magnets can connect and become lodged in the digestive system. This can result in perforations, intestinal blockages, infection, blood poisoning and death.
  The CPSC notes: "CPSC estimates 2,400 magnet ingestions were treated in hospital emergency departments from 2017 through 2021. CPSC is aware of seven deaths involving the ingestion of hazardous magnets, including two outside of the United States."
  About 4,240 of the magnet sets were recalled Dec. 28, 2023. They were manufactured in China, sold by Shanghai Yanlei Network Technology Co. Ltd., of China, through JD E Commerce America Limited (dba Joybuy), of Irvine, California and sold exclusively at Walmart.com from February 2022 through April 2023 for $14 to $15.

- **Moonsea Pack and Play Mattresses**
  These were determined by the CPSC to be a suffocation hazard to infants. The China-based company was sent a Notice of Violation on Sept. 22, 2023 because the crib mattresses violated several parts of

federal safety regulations, including thickness and missing labels. About 11,000 of the mattresses were recalled Dec. 7, 2023. They were manufactured in China, imported by Huangshan Yueyang Ecommerce Co. Ltd., of China and sold exclusively on Amazon.

The CPSC can't just recall toys known to be dangerous

The second reason why the 23 toy recalls in 2023 don't paint the whole picture: For the number of toys recalled every year, we're talking about only toys the CPSC believes are dangerous *and* that the CPSC can actually recall. Virtually all recalls announced by the Consumer Product Safety Commission are voluntary by the company; the CPSC can't easily mandate recalls without legal action. And the CPSC can't recall counterfeit products; the CPSC can't really recall something that isn't supposed to exist.

Because the CPSC doesn't have the authority to mandate the recall of a dangerous product, recalls of toys and other dangerous products often take months or years. Here are two examples of toys manufactured in China that were recalled in 2023 – years after the CPSC knew they posed significant safety risks.

- **Calico Critters**
  Back in May 2018, a medical examiner in New Mexico filed a report with the CPSC regarding a 2-year-old girl he performed an autopsy on. "It was revealed she had a small part of a toy pacifier in her bronchus," the report said. The toy pacifier came from the Calico Critters toy line, specifically the Yellow Labrador Twins set, by Epoch Everlasting Play, the report said. It was manufactured in China. Epoch was also aware of two other incidents, including the death of a child in Japan in 2015.
  We wrote about Calico Critters in our 2020 Trouble in Toyland report, noting the danger they posed because they contained small parts, but these toys were clearly aimed at children under 3. In fact, the company marketed them in the list of toys intended for children under 3. They were sold at Amazon, Meijer, Walmart and other stores

nationwide from January 2000 through December 2021 for between $10 and $80.
On March 9, 2023, nearly five years after the first death reported to the CPSC, Epoch Everlasting recalled 55 varieties of these toys, totaling 3.2 million products, valued at $32 million to $256 million.

- **Robo Alive Shark Swimming Bath Toys**
  In September 2020, a 1-year-old baby girl slipped in the bathtub and fell on a Zuru Robo Alive Baby Shark and began bleeding in her groin area. She was rushed to the hospital. She had internal bleeding and cuts in two areas. Her mom complained to the CPSC that the fin of the shark was just too sharp.
  In February 2022, a 19-month-old boy was playing in the bathtub and slipped and fell on the shark and the fin caused a “cut and trauma to his anus.” He was treated by a doctor. “My son is terrified of diaper changes and baths now due to his injury! This was very traumatic for him and it shouldn't happen to anyone else's children,” the boy’s parent wrote in the report.
  These were among 12 incidents reported involving the baby shark, going back to at least 2018. Five years later, on June 22, 2023, Zuru recalled 7.5 million of the baby shark toys, which were manufactured in China. Customers were entitled to refunds. The value of the products recalled: $136 million.

Last year, the CPSC issued 38 warnings regarding products it *wants* to get recalled, but the companies either won’t cooperate or won’t respond. The CPSC doesn’t have mandatory recall authority over the roughly 15,000 products it regulates. Again, it can’t force a company to recall a product without taking legal action. Of the 38 warnings, 12 were for toys and eight were for infant sleep products. Others were a children’s scooter, a children’s bike helmet, a high chair and an infant sling. There were only a few products that weren’t designed for children. Of the 38, 35 were imported; 20 were manufactured in China.

Counterfeit toys

Besides the fact that the CPSC can't issue mandatory recalls without going to court, the CPSC can't recall toys or any other product if they're counterfeit. There's no such thing as recalling something that's not supposed to be for sale.

Bad actors frequently create counterfeits or knockoffs of name-brand toys that are in high demand and may be difficult for families to find at mainstream retailers. Counterfeit and knockoff toys are a threat because they often don't comply with U.S. safety standards and they're not tested to see whether they comply. Many are low-quality and can break easily and cause injuries, or they contain toxics, or both.

In FY23, the CPSC, in collaboration with U.S. Customs and Border Protection, seized more than 1.1 million toys that were dangerous or illegal. About 101,000 of those were lead-related.

Meanwhile, Customs and Border Protection in FY22 (the latest statistics available) says it seized 101 shipments of toys from China (with 274 lines or different types or brands of products) for copyright infringement, meaning they're counterfeit. A single shipment seized on a given day could contain hundreds or thousands of the same item. So 101 shipments could mean tens of thousands or hundreds of thousands of toys. Seizures from all countries in FY22 totaled 165, with 381 lines of products. (See chart images in the appendix.)

That 101 shipments in FY22 is up from 77 shipments of counterfeits from China in FY21. Does that mean there are more counterfeit products, or just more getting detected and seized? Who knows. Either one is bad. Even one counterfeit toy that violates safety standards, not to mention that is harming legitimate businesses, is too much.

An example from FY22: the CBP in New Orleans in 2022 seized 1,807 pop fidget toys that had copyright and trademark infringements. They had targeted three international shipments for inspection, each with hundreds of fidget toys designed to look like popular brands, including Yoda, Spiderman, The Hulk and Bart Simpson. The shipments originated from Shenzhen, China, and were going to a local address in New Orleans. CBP said Shenzhen is frequently the source of all sorts of counterfeit items.

Here is one of the counterfeit "Bart Simpson" pop-em fidget toys seized by U.S. Customs and Border Protection in January 2022.

It's troubling that counterfeit toys, especially dangerous ones, may be imported and slip under the radar. U.S. Customs and Border Protection can't open every container, inspect every piece of paperwork and test every toy. And the CPSC's Office of Import Surveillance has enough staffing only to have investigators at about 6% of CBP's 327 ports of entry, often with only one investigator.

The impact of online shopping

The backdrop here is consumers overall seem to be more comfortable with online shopping. That's another post-COVID phenomenon. But with shopping online comes a greater risk of buying a counterfeit product. It's often difficult for regulators to combat at times because many shoppers today order directly from international sellers, not from a large, well known online marketplace.

Or, we order from an online platform, thinking it's a U.S.-based seller, with no indication where the product is being shipped from. In some cases, online sellers will say they're located in Dayton, N.J. or Oxnard, Cal. – cities known to have a significant number of international reshipper warehouses. But the products are actually coming from China. I'd argue that consumers would be leery of buying anything that's misrepresenting where it's coming from.

In any case, regardless of the sender's address, small shipments addressed to an individual's home are less likely to be opened and inspected at the border.

Another cause of this problem of dangerous, imported toys: Companies don't really have strong disincentives. They can often import or sell toys and other products they know are dangerous or counterfeit, or illegal for other reasons, without fear of huge consequences.

For example, in August 2022, the CPSC said that Segway Powersports Inc. (SPI) of McKinney, Texas, was assessed a $5 million civil penalty to resolve charges that it "knowingly imported" ATVs without a CPSC-approved ATV action plan. That's a violation of CPSA. The ATVs were imported from China. ATVs require a CPSC-approved action plan by federal law to "promote the safe and responsible use of ATVs, particularly for children under age 16."

Now, $5 million might sound like a lot of money, but the CPSC suspended all but $1.25 million of it. Commissioner Peter Feldman criticized the decision as a slap on the wrist:

"Such blatant disregard for our safety laws, at a minimum, should have resulted in a higher penalty. A civil penalty between $7 and $10 million would have been consistent with recent Commission precedent. Instead, the Commission chose to impose, and then to suspend, a $5 million penalty based on SPI's asserted inability to pay. I'm skeptical of this claim. Does anyone really believe that a Chinese subsidiary is not backed by the full faith and credit of its parent and ultimately the Chinese government? I don't. Ninebot is a billion-dollar company with cash reserves in the hundreds of millions of dollars and access to vast amounts of additional Chinese capital."

But a couple thousand imported children's products, mostly toys, are flagged every year for violating some safety standard. Most simply receive notices of violation and are told to stop selling the products already on the market, correct future production, change labeling or, in a small percentage of cases, recall the product.

The CPSC pursues much larger financial penalties with companies that fail to report injuries, deaths or serious incidents, as is required by law. But these penalties still aren't large enough in many cases. For example:

- **May 5, 2023**
  Generac Power Systems, Inc., of Waukesha, Wis., agreed to pay a $15.8 million civil penalty. The settlement follows charges by the CPSC that Generac failed to report complaints questioning the safety of its portable generator for more than a year, from October 2018 and into 2020. They were manufactured in the United States and China. When Generac finally told the CPSC, five people had already suffered finger amputations while trying to move their generator. Generac and the CPSC announced a recall of 321,160 generators on

July 29, 2021.

- **Sept. 29, 2023**
  BJ's Wholesale Club Inc. of Marlborough, Mass., agreed to pay a $9 million civil penalty. The settlement follows charges by the CPSC that BJ's intentionally failed to report that Royal Sovereign brand portable air conditioners it sold contained a defect that put customers at risk of injury or death. The products were manufactured in China.
  BJ's sold 1,778 of these air conditioners in 2011 and 2012, and 509 of them were returned to the store. In August 2016, one of the air conditioners sold by BJ's was involved with a fire at a house in New York, with a woman and her two children inside. They were rescued, but the woman later died. BJ's was informed about the fire no later than March 2017 and issued a warning to customers in March 2021 but still didn't inform the Commission, CPSC Chair Alex Hoehn-Saric said in a statement. Royal Sovereign and the CPSC announced a recall of 33,570 air conditioners on December 22, 2021.

- **November 08, 2023**
  HSN Inc., of St. Petersburg, Fla., agreed to pay a $16 million civil penalty. The settlement follows charges by the CPSC that HSN intentionally failed to report that its Joy Mangano-brand My Little Steamer and My Little Steamer Go Mini contained a defect that could cause injuries. The products were manufactured in China.
  From late 2012 until early 2019, HSN received "numerous" complaints that the steamers "would spray, expel, and/or leak hot water while in use, resulting in serious and permanent injuries, a limited number of which constituted grievous bodily injury." When HSN finally told the CPSC, it had received about 400 complaints of the steamers spraying or expelling hot water and about 700 more reports of leaks. Among the complaints: at least 91 injuries and 29 insurance claims regarding injuries including second and third-degree burns and one case of hearing loss. There were about 650 additional

complaints on HSN Online Reviews. HSN and the CPSC announced a recall of 5.4 million steamers on May 26, 2021.

Two of these cases were near the maximum civil penalty the CPSC can assess, which is currently $17.5 million. These companies failed to notify the CPSC within 24 hours, as required by law, when they receive information that "reasonably suggests" one of their products could pose a health or safety risk. Yet they couldn't be penalized more than $17.5 million, even after their products were connected with serious injuries or, in one case, a death.

Recommendations

In conclusion, PIRG has several recommendations for Congressional action related to product safety in general and specifically for toys imported from China.

- Support the Sunshine in Product Safety Act, or similar legislation, which would allow the CPSC to warn consumers more quickly about all kinds of dangerous products, including toys, when there's a grave threat involving a product in people's homes. It was first introduced in 2021. It was reintroduced in March 2023 in the House and Senate.

- Congress or courts would act to clarify that the 1996 Communications Decency Act doesn't insulate online platforms from responsibility for products sold illegally on their websites. This would give the CPSC more authority to pursue enforcement against platforms such as Facebook Marketplace and eBay, just like the regulator does with big box retailers. Currently, the CPSC can't require an online marketplace to remove a product from its platform or notify the CPSC of hazards or injuries unless the marketplace is a manufacturer, distributor, importer or retailer.

- Bolster the resources of Customs and Border Protection and the CPSC to provide more staffing at the border to stop dangerous imports, especially toys and other products, from entering the country. The bipartisan Securing America's Ports of Entry Act would provide more CBP staffing, although not necessarily focused on counterfeits and other dangerous products.

- Empower the CPSC with mandatory recall authority in cases where the CPSC believes a product represents a grave threat, based on reports from hospitals, fire departments, coroner and complaints from consumers. The CPSC should also be authorized to recall a dangerous product when a company isn't being responsive, especially an international company.

- Pass the CAP Act, which would increase the civil penalties companies could face if they violate product safety laws and endanger people, especially children.

- Pass the Ban Water Beads Act, which would categorize water beads as a hazardous product under section 8 of the Consumer Product Safety Act. The bill was introduced following the July 2023 death of a 10-month-old baby in Wisconsin who had swallowed water beads, and the serious injury of a 9-month-old baby in Maine who had swallowed water beads, which caused an intestinal obstruction that required surgery.

  About 7,800 children were treated in emergency rooms from 2016 through 2022 for injuries or illnesses caused by water beads, according to data from the CPSC.

  Buffalo Games recalled about 52,000 Chuckle & Roar Ultimate Water Beads Activity Kits on Sept. 24, 2023. The product was connected to the death of the Wisconsin baby and injury of the Maine baby. The water beads were manufactured in China and imported by Target Corp. of Minneapolis, Minn.

- Empower the CPSC to continue to research the risks of phthalates and other toxics. Laws were passed on lead and some phthalates in children's products. There are more toxic chemicals we should learn more about.

- Give the CPSC more resources. The CPSC is supposed to protect the public from dangers that may exist with 15,000 different kinds of consumer products. The expectations for the CPSC are enormous: setting mandatory safety standards; influencing voluntary safety standards; requiring labeling; forcing hazardous products to be removed from store shelves; pursuing product recalls; educating the public about product safety; and collecting and analyzing data about injuries, death and incidents. The CPSC reviews about 8,000 unintentional product-related death certificates each year, and tracks at least 15.5 million injuries each year that are treated in emergency rooms and associated with consumer products.

- Consider strengthening the bi-partisan INFORM Consumers Act, which went into effect June 27, 2023. The INFORM Consumers Act requires online marketplaces to verify "high-volume" third-party sellers by authenticating the seller's government ID, tax ID, bank account information, and contact information. And makes it much more difficult for a bad guy to use burner accounts, unless he or she had multiple government-issued IDs. "A high-volume seller is defined as any seller that, in a continuous 12-month period, has entered into and completed 200 or more discrete sales or transactions and, as a result, has accumulated an aggregate total of $5,000 or more in gross revenue."

  But the law won't stop smaller sellers, who might sell fewer than 200 items in a year. And it doesn't do anything to deal with counterfeits at brick and mortar stores.

- Work to fix the broken product recall system, by requiring companies to do more to notify customers about recalls and by requiring companies with recalled products to have a consumer-friendly process to get a refund, repair or replacement.

We know this is possible because so many companies large and small do this already. Half of the companies that offered refunds in 2023 had a reasonably easy remedy request process, according to research and an analysis we published last month in our Too Much To Recall report.

When recalls are difficult to get, dangerous products remain in people's homes, with the potential for even more calamities.

The bottom line here: About 200,000 people are treated in emergency rooms every year for toy-related injuries. About three-fourths of those – 150,000 – are sustained by children 14 years old or younger; more than one-third – about 70,000 – are sustained by children 4 years old or younger.

And the 23 toys that were recalled last year are implicated in 68 injuries and the deaths of three children, so far. There are far, far more dangerous toys out there than just the ones recalled every year.

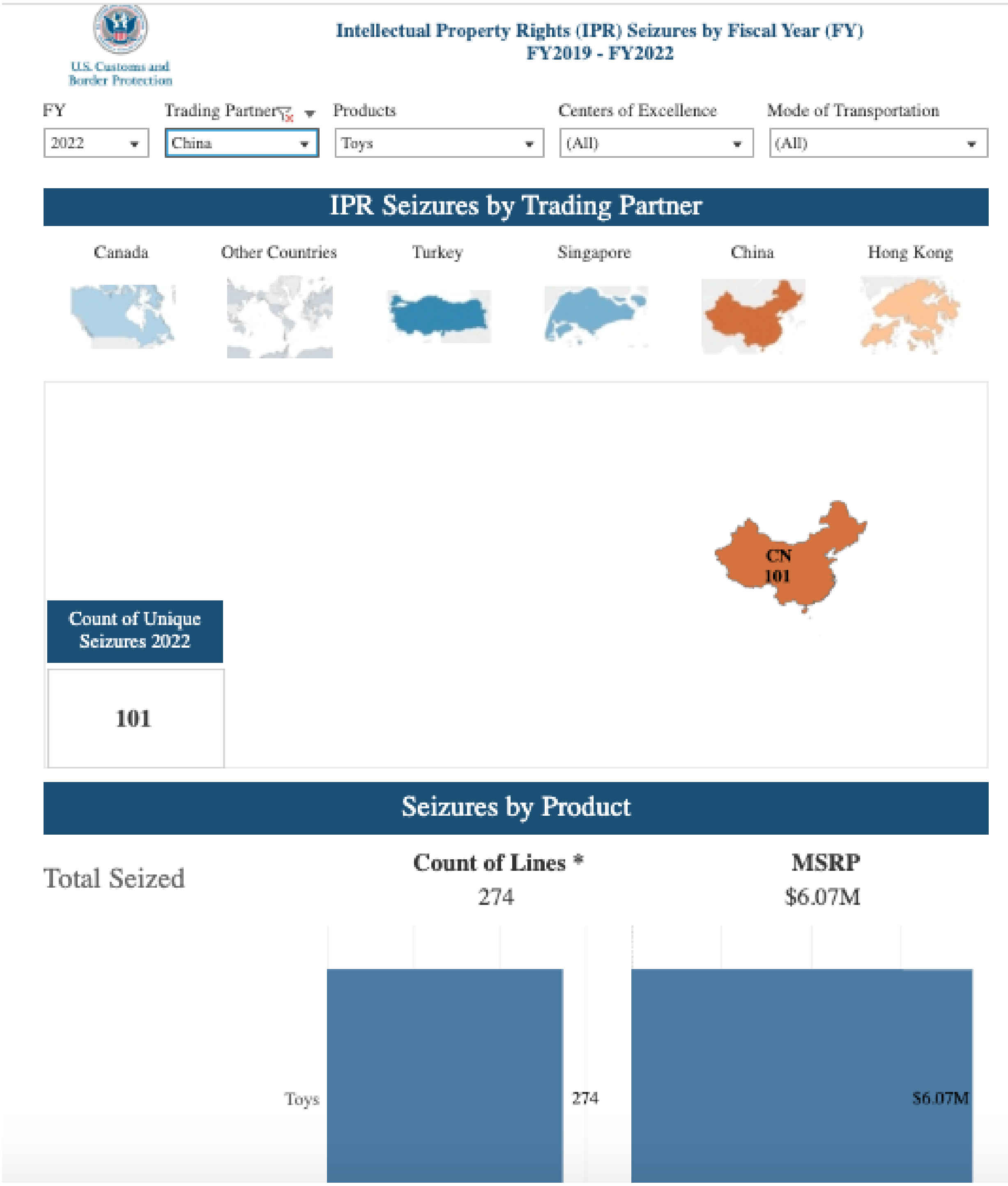
We know that parents, caregivers, families and shoppers of all types generally assume that because something is for sale, it must be safe. Of course that's often tragically wrong.

Thank you for your time.

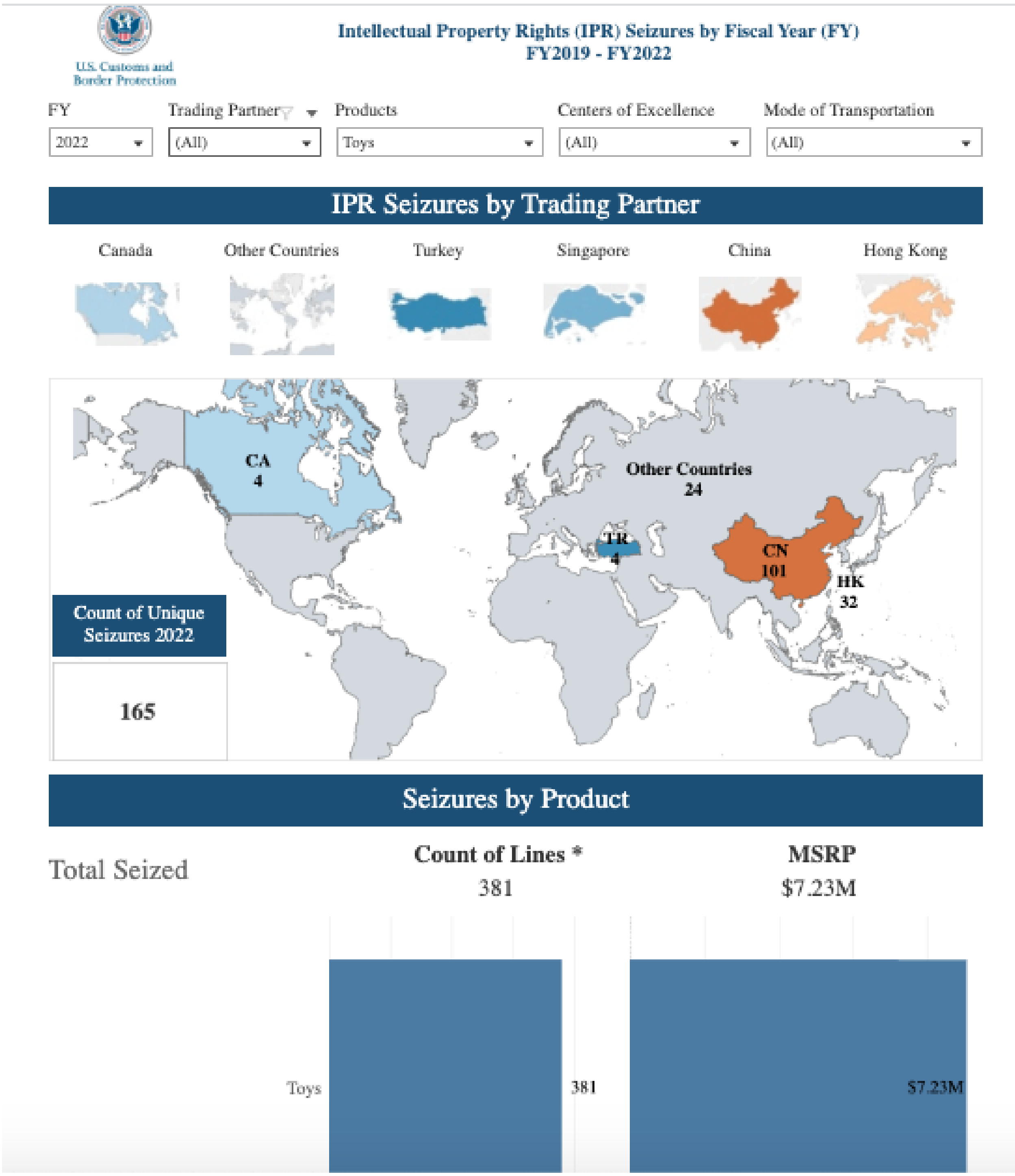
Please see appendix images below.

Data from Customs and Border Protection

Seizures of products that violate intellectual property rights from China in FY22.



Seizures of products that violate intellectual property rights from all countries in FY22.



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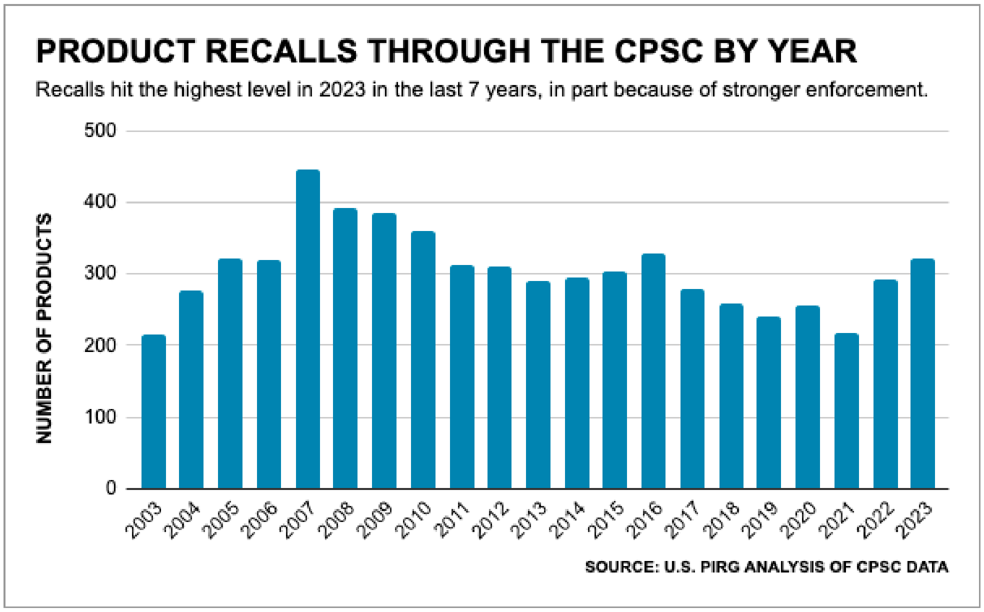
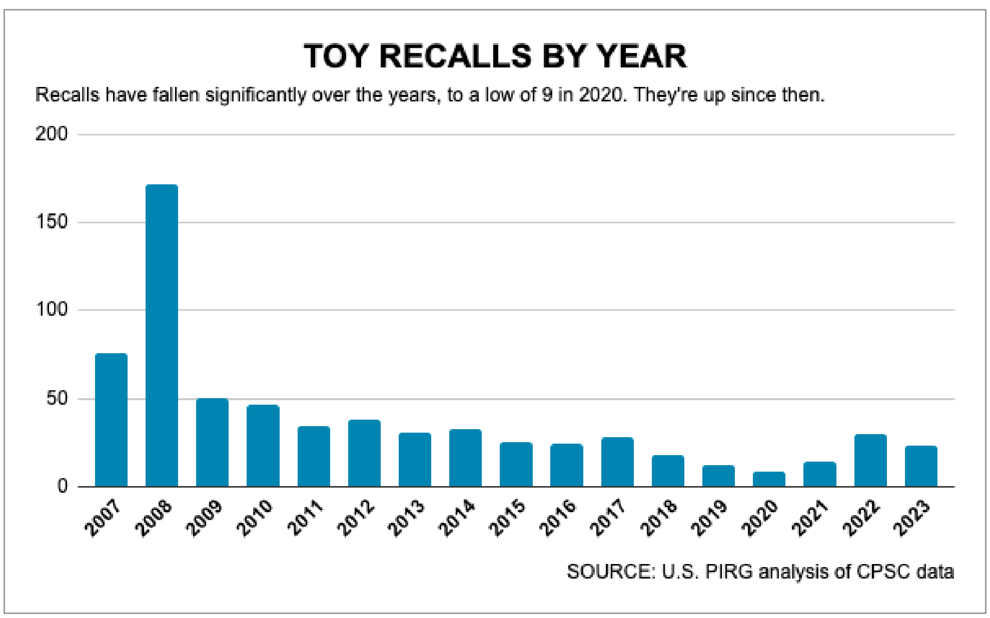
RECALLS OF ALL PRODUCTS AND TOYS

In 2007, awareness grew that many children's products violated lead standards for paint and surface coatings. The maximum level for paint and surface coatings of toys and other children's products was 600 ppm, a standard set way back in the 1970s. That led to an increase in recalls in 2007. Among the 447 recalls that year, more than 100 stemmed from excessive levels of lead in paint. That fueled greater focus on children's products in 2008, especially toys that children often put in their mouths. In 2008, Congress passed the CPSIA that restricted lead content in children's products.





OPENING STATEMENT OF DANIEL SHAPIRO, SENIOR VICE PRESIDENT OF BRAND RELATIONSHIPS AND STRATEGIC PARTNERSHIPS, RED POINTS

COMMISSIONER GLAS: Thank you. Dan.

MR. SHAPIRO: Thank you, Chairwoman Cleveland and Commissioner Glas and esteemed members of the Commission for inviting me today. I am Daniel Shapiro, Senior Vice President of Brand Relationships and Strategic Partnerships at Red Points. Red Points is an AI solution that detects and removes online fraud such as counterfeit, illegal goods, and brand impersonation. Our mission is to make internet safer for both brands and consumers and improve overall trust.

I've been in this space for over 14 years, starting at eBay where I led a criminal investigation team and then spearheaded eBay's first ever proactive brand protection team which included close collaboration with global brands to combat counterfeiting. During this time, I've seen a concerning rise in the sale of counterfeit goods which is already the world's largest criminal enterprise according to the U.S. Patent and Trademark Office.

The safeguard of anonymity, the low barriers to entry make e-commerce the perfect venue to hide in plain sight. Red Points removed 4.6 million infringements last year, but because of a lack of transparency on many e-commerce platforms, it is difficult to precisely identify the origin of the sellers. Only 14 percent of the removed infringements revealed the seller of country, 40 percent of that was originating from China. The problem shows no sign of slowing down and Red Points' data reveals that in 2022 and 2023, we saw an increase of 26 percent more infringements compared to the previous two years. While these numbers are significant, we know they're just the tip of the iceberg because shipping location data is just not available.

There are four main channels through which Chinese counterfeit goods reach American consumers. Number one, Chinese international marketplaces, like Alibaba, AliExpress, DHGate, JD.com, Shein, they're primarily Chinese sellers who want access to American consumers and it accounts for 86 percent of the Chinese counterfeit goods that targeted U.S. consumers according to our data.

Number two, domestic U.S. global marketplaces such as Amazon, eBay, and Walmart, have the option to show shipping location as China and this contributes another six percent to the issue. However, many sellers may import and warehouse product directly in the U.S., masking the origin of the product. So for instance, we could have a seller in Wisconsin shipping from Wisconsin, and we wouldn't have visibility as to where that product really originated from

And number three, Chinese domestic marketplaces such as Taobao, Tmall, 1688, those are marketplaces designed -- Chinese marketplaces designed to sell into the Chinese consumer. However, new third party drop shipping platforms like Pandabuy allow U.S. consumers to buy directly from those sites and that represents another 8.5 percent of our data.

And number four, standalone e-commerce sights or e-shops which we identify are registered in China experienced a 225 percent increase in our infringement data from 2022 to 2023. Unfortunately, data on how much product they had shipped or transacted before we took them down is not available.

Counterfeiters are driven by high profits and constantly adapt their techniques within these online distribution channels to bypass detection. A recent example is mobile-only e-shops, meaning fraudsters use social media to drive traffic to a URL, to a website, and when you open it up on your desktop or a laptop, it is benign goods and they're non-irrelevant. But when you look at it on your mobile device, it's full of counterfeits and goods ready to ship to the U.S.

Another popular tactic is hidden listings where a non-branded item on a marketplace is concealing a counterfeit good. Counterfeiters use social media posts, private messaging to state the equivalence between what is listed and what will ship. An example of this could be a basic green t-shirt could actually be a Gucci handbag. Apart from these techniques, counterfeiters use other simple, yet effective, techniques from misspelling the brand on purpose to terms like designer makeup even though the brand is clearly marked on the product and marked on the packaging. The consequence of these illegal activities are multi-fold. From an economic standpoint, the sale of counterfeit cost to U.S. consumers is over $200 billion annually and displaces over 750,000 jobs according to the U.S. PTO.

However, it extends far beyond the concerns. Fake goods aren't just knock off of designer brands. The problem is vast and they pose a real threat to consumer health and safety. Some counterfeit categories might be obvious like baby toys, beauty, health supplements, medicines, and even apparel can be dangerous when the chemical used to dying the product is harmful to citizens. But there are serious concerns around electronics, tools, machine parts, automotive, and aircraft components.

Virtually every industry is impacted by counterfeit goods. These products do not conform to any regulation, nor do they abide by any safety standards. The presumption should be that counterfeits are dangerous all the time. Most U.S. brands face consumer complaints or lawsuits from imposter products. The reputational damage to these brands are real

Our recommendation to consumers is to verify product details when shopping online. Check seller reviews. Seek brands with authenticated measures and it's okay to be skeptical. We encourage brands to utilize monitoring and enforcement systems across the expansive e-commerce environment and forge collaborations. We think deploying technology is a must.

And to the Commission, we'd like to express that collective action is paramount. We humbly suggest a multi-prong approach: enhancing transparency in e-commerce platforms, fostering collaborations to facilitate swift takedowns of counterfeit listings, and launch awareness campaigns to educate unintentional consumers or counterfeit seekers about the dangers of counterfeits. By working together we can safeguard the integrity of our markets and the well-being of our citizenry.

Thank you for your time this morning and I welcome your questions.

PREPARED STATEMENT OF DANIEL SHAPIRO, SENIOR VICE PRESIDENT OF BRAND RELATIONSHIPS AND STRATEGIC PARTNERSHIPS, RED POINTS

Testimony before the U.S.- China Economic and Security Review Commission

Hearing on Consumer Products from China: Safety, Regulations, and Supply Chains

Written Testimony of
Daniel Shapiro
Senior Vice President, Brand Relationships and Strategic Partnerships, Red Points

Foreword

Honorable Members of the Commission,

Thank you for the opportunity to appear before you today. My name is Daniel Shapiro, and I am the Senior Vice President for Brand Relationships and Strategic Partnerships at Red Points.

In my testimony before this Commission, I will provide a comprehensive overview of the effects of counterfeit products shipped from China have on U.S. consumers, brands, and the broader U.S. economy. The testimony will delve into various key factors, including the remarkable expansion of international Chinese marketplaces. Furthermore, I will draw upon insights and data from Red Points' platform to illustrate the current state of the counterfeit crisis based on the extensive dataset we have collected over the years. This will include exploring the steps that can be taken to protect unsuspecting U.S. consumers and organizations from these risks. My objective is to provide insight on this complex issue to the Commission.

Daniel Shapiro's background

Before I start, I would like to briefly introduce myself and explain why I believe my expertise can provide value to the Commission.

For 30 years as a career retail executive working with many of the most famous brands in the world, I have valued and protected the relationship of authentic goods. I began this journey as a Merchandise Manager and later a Senior Buyer for Men's Athletic Shoes at Macy's, lasting nearly 6 years. Followed by a 24-year career as President and CEO of Shapiro Luggage and Gifts, an eight-store specialty retailer in three States. Later on, I entered the world of brand protection at eBay, where I helped the e-commerce platform create its first-ever global proactive brand protection team. My roles evolved during my almost 8 years at eBay, providing me with a 360-degree picture of counterfeiting and what it meant for the marketplace, brands, legitimate sellers, and ultimately the impact on the end consumer.

For the past six years, I have been part of the Red Points team, leading the company operations in North America. During this tenure, I have been instrumental in expanding our brand relationships and have made significant strides in enhancing and fortifying our ties with marketplaces, social media platforms, and registrars. For Red Points, maintaining a healthy partnership with these e-commerce platforms is paramount to the success of our clients' brand protection programs. This, together with our AI-driven platform, enables us to effectively detect and enforce online fraud worldwide.

Red Points overview

Red Points is the world's most widely used AI platform to stop counterfeits, impersonation, piracy, and brand abuse. More than 300 software engineers and industry experts have built it together with some of the world's largest companies for the past decade, and today it offers a remarkably advanced and customizable suite of products that protect organizations across marketplaces, websites, social media, apps, and NFT platforms.

As of today, over 1,300 companies rely on our platform to combat online fraud. Just last year, Red Points processed 60 million links per day, enforced 4.6 million infringements, and safeguarded an estimate of $2.2 billion in revenue for our customers[1]. Currently, we send approximately between 350,000 and 400,000

[1] Based on enforced listings' stock and selling price.

cease and desist notices a month, numbers that highlight the scale of the issue of online intellectual property infringements.

Our client base includes some of the world's largest brands spanning all five continents, with several Fortune 100 companies among them, as well as small and medium businesses, and represents a large list of industries, such as toys, sports, cosmetics, fashion, electronics, homeware, and CPG (consumer packaged goods) among others.

At Red Points, we firmly believe that continuous innovation is the best response to intellectual property threats. Our commitment to developing truly scalable, adaptive, and user-friendly technology has empowered us to build the world's most advanced platform to fight counterfeiting and brand abuse, and ultimately progress toward our corporate mission: making the Internet a safer place for brands and consumers.

Section 1: Evolution of e-commerce and its impact on U.S. buyers

The e-commerce boom

In the last ten years, the realm of online shopping has undergone a remarkable metamorphosis. In 2010, a mere 5%[2] of retail sales occurred through digital channels. However, the landscape of e-commerce experienced a rapid ascent over the decade, with online sales soaring to 18%[3]. This staggering growth was particularly pronounced in 2020 when e-commerce sales surged by an impressive 44%[4].

In this context, addressing the problem of counterfeiting without acknowledging the rapid expansion of e-commerce, which has significantly altered consumer purchasing behaviors and provided international sellers with new platforms to reach a worldwide audience, would be to overlook a critical component of the issue.

In fact, quantitative analyses, which we will cover later in this testimony, explore the direct connection between e-commerce and counterfeit trade. Specifically, they examine the relationship between the growing e-commerce sector and the frequency and value of customs seizures of counterfeit goods during the period of 2017-19.[5]

Similarly, it's undeniable that the COVID-19 pandemic served as a catalyst for this e-commerce boom. The pandemic-induced reliance on online shopping opened the doors of e-commerce to a diverse array of demographic groups, many of whom were previously underrepresented or ill-equipped for online

[2] Rheude, Jake. 2023. "ECommerce Growth From 2010 to 2020." Red Stag Fulfillment. December 22, 2023. https://redstagfulfillment.com/2010s-ecommerce-growth-decade/#:~:text=Since%202010%2C%20global%20eCommerce%20sales%20have%20increased%20by%20nearly%20800%25.

[3] Rheude, Jake. 2023. "ECommerce Growth From 2010 to 2020." Red Stag Fulfillment. December 22, 2023. https://redstagfulfillment.com/2010s-ecommerce-growth-decade/#:~:text=Since%202010%2C%20global%20eCommerce%20sales%20have%20increased%20by%20nearly%20800%25.

[4] Rheude, Jake. 2023. "ECommerce Growth From 2010 to 2020." Red Stag Fulfillment. December 22, 2023. https://redstagfulfillment.com/2010s-ecommerce-growth-decade/#:~:text=Since%202010%2C%20global%20eCommerce%20sales%20have%20increased%20by%20nearly%20800%25.

[5] Misuse of E-Commerce for Trade in Counterfeits. 2021. Illicit Trade | OECD and European Union Intellectual Property Office. October 25, 2021.https://www.oecd-ilibrary.org/sites/1c04a64e-en/index.html?itemId=/content/publication/1c04a64e-en.

purchasing. This led to a noticeable inclination towards prioritizing convenience and cost-effectiveness in shopping, changes that have redefined the retail landscape and consumer expectations.

Last but not least, this era of e-commerce expansion was also marked by the rise of major players, such as Amazon, Alibaba, and Facebook Marketplace. Alibaba, though rooted in China, transcended its national boundaries to become a global player in online retail, gaining a strong foothold in worldwide markets, notably in the United States. Since 2010, Alibaba has witnessed a sizable growth of over 12,000%[6], a testament to its expanding influence and reach.

ECOMMERCE GROWTH IN THE U.S.

2010		2020
$165.4 billion	U.S. Retail Purchases Made Online	**$861.12 billion**
$572 billion	Global ECommerce Sales	**$4.2 trillion**
$34.2 billion	Sales Made on Amazon	**$386 billion**
$845 million	Sales Made on Alibaba	**$109 billion**
4.6%	**ECommerce as a Share of U.S. Retail Sales**	**18%**

Source: redstagfulfillment.com

Section 2: Role of e-commerce in counterfeit distribution within the U.S.

How e-commerce facilitates counterfeit sales

The exponential growth of e-commerce combined with an ease of access to these platforms, has significantly opened up avenues for counterfeit goods, particularly those originating in China. Online marketplaces, by their very design, offer sellers a degree of anonymity and remarkably low barriers to entry, enabling counterfeiters to infiltrate and exploit global markets and pose significant threats to consumers, businesses, and intellectual property rights holders.

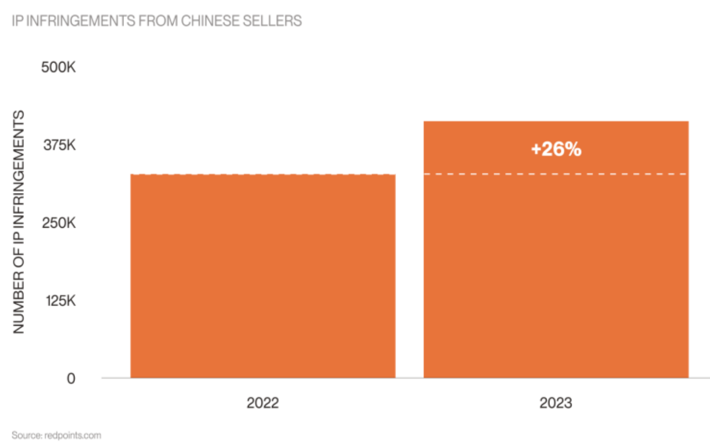
Not only are counterfeiters readily accessing these platforms, but they are also continually evolving their methods to circumvent detection. While law enforcement and regulatory bodies are vigilant in identifying fraudulent websites and collaborating with major platform operators and brand owners to curtail the sale of counterfeits, the challenge remains persistent and continues to escalate.

[6] Rheude, Jake. 2023. “ECommerce Growth From 2010 to 2020.” Red Stag Fulfillment. December 22, 2023. https://redstagfulfillment.com/2010s-ecommerce-growth-decade/#:~:text=Since%202010%2C%20global%20eCommerce%20sales%20have%20increased%20by%20nearly%20800%25.

Meanwhile, the referred-to level of anonymity afforded to counterfeiters severely restricts the visibility of available public data, providing an incomplete picture of the true magnitude and origin of counterfeit goods entering the U.S.

Out of all seller data processed in 2022 and 2023 by Red Points, only 14% of infringing marketplace sellers displayed geolocation information, which reveals a severe transparency deficit in many e-commerce platforms. However, when looking at sellers with confirmed geolocation information, 40% of those identified within this two-year period were based in China.

When comparing those two years, 2022 and 2023, Red Points records show an uptrend both with regards to the number of Chinese sellers engaging in infringing activities (+12% year over year) and the volume of infringements committed by those sellers (+26% year over year).



These figures present a clear trend and reflect the ease at which counterfeit goods, particularly those from China, are infiltrating international markets via online platforms, challenging both consumers and businesses in identifying and combating this illegal trade.

Quantifying the issue of counterfeit goods in the U.S.

As mentioned above, the issue of counterfeiting has undergone a rapid evolution beyond the traditional confines of street corners and flea markets.

As of 2018, counterfeiting ranked as the largest criminal enterprise globally, with sales of counterfeit and pirated goods totaling an estimated $1.7 trillion to $4.5 trillion annually, surpassing the revenue from both drugs and human trafficking[7].

This significant increase is mirrored in data collected by the U.S. Department of Homeland Security (DHS). Between 2000 and 2018, DHS reported a tenfold increase in the seizure of infringing goods at U.S. borders, with annual seizures growing from 3,244 to 33,810[8]. Even more telling is the domestic value of these seized items based on the manufacturer's suggested retail price (MSRP) of the legitimate goods, which reached the staggering amount of $1.4 billion in 2018[9].

The expected growth of e-commerce amplifies concerns that the extent of this problem could escalate further, particularly if current practices continue without significant changes.

[7] Bharadwaj, V. P., Marieke Brock, Bridey Heing, Ramon Miro, and Noor Mukarram. 2020. "U.S. Intellectual Property and Counterfeit Goods—Landscape Review of Existing/Emerging Research." *Social Science Research Network*, January. https://doi.org/10.2139/ssrn.3577710.

[8] "Combating Trafficking in Counterfeit and Pirated Goods" 2020. Homeland Security | Office of Strategy, Policy & Plans. https://www.dhs.gov/sites/default/files/publications/20_0124_plcy_counterfeit-pirated-goods-report_01.pdf

[9] "Intellectual Property Rights Fiscal Year 2018 Seizure Statistics" 2018. U.S. Customs and Border Protection | Office of Trade https://www.cbp.gov/sites/default/files/assets/documents/2019-Aug/IPR_Annual-Report-FY-2018.pdf

Section 3: China-originated counterfeit trade and U.S. consumer access

China's role in global and U.S. counterfeit goods trade

China's involvement in the global counterfeit goods trade has made a substantial contribution to the burgeoning issue of counterfeit goods entering the U.S. This issue is not merely growing, it is rapidly escalating, posing a significant threat to the U.S. economy and its consumers' safety.

According to the Office of Trade, U.S. Customs and Border Protection, a substantial portion of counterfeit goods entering the United States originates from Mainland China (46%) and its Hong Kong territory (41%)[10].

Entry points for online Chinese counterfeits in the U.S.

According to Red Points' platform data, the influx of counterfeit goods from China into the U.S. market is multi-pronged, with e-commerce platforms at the forefront.

Chinese counterfeit online distribution can be classified into four main groups:

1. Chinese marketplaces shipping internationally

Due to their large transaction volume, these e-commerce platforms emerge as the predominant source of counterfeit distribution, accounting for a staggering 85.9% of all China-originated infringements reported by Red Points. Some of the most popular examples are Alibaba, DHGate, JD.com, Temu, Shein, and AliExpress.

These sites offer American consumers a massive assortment of products that can be shipped to the U.S., and have shown to be facilitating the majority of counterfeit listings our customers have reported. In most cases, the method of entry for these goods into the U.S. is through small postal shipments, posing a significant challenge to track and regulate the influx of these items.

2. U.S. and global online marketplaces

American marketplaces like Amazon and eBay and international marketplaces that allow shipping into the U.S. are also used by Chinese counterfeiters. Based on Red Points data, even though this group accounts for 5.1% of all China-originated infringements on our platform, it saw a 64% increase in cases between 2022 and 2023.

3. Chinese standalone e-shops

Although marketplaces offer a low entry barrier to counterfeit sellers by design, the building and hosting of single e-commerce websites have been significantly commoditized in the past few years.

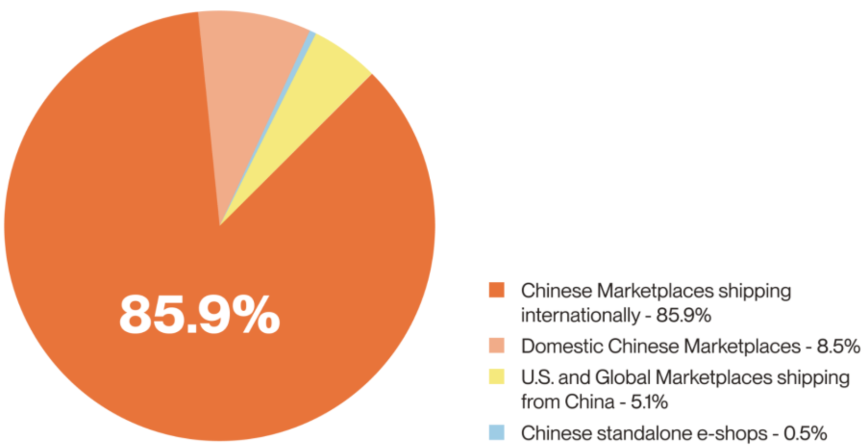
In fact, stand-alone websites registered with Chinese hosting saw a 224% increase in infringements from 2022 to 2023 as observed by Red Points, despite accounting for only 0.5% of China-originated infringements volume. However, due to the lack of reliable data regarding stock or transactions, the actual volume of counterfeited products sold through these sites is presumably far more significant.

[10] Solutions, Syed M. Zubair Bokhari - Xdimension. 2011 "Supply Chain News: The Enormous Cost of Counterfeit Goods to US Manufacturing." https://www.scdigest.com/ontarget/21-11-10_counterfeit_goods_growing_problem.php?cid=19254

4. Domestic Chinese marketplaces combined with drop-shipping services

Bad actors also utilize Chinese marketplaces designed for domestic use, like Taobao, TMall, and 1688 to funnel counterfeit goods into the U.S. through third-party drop-shipping platforms like Pandabuy. Infringements in these sorts of platforms account for 8.5% of the infringements in Chinese sites recorded by Red Points.

MAIN E-COMMERCE CHANNELS USED BY CHINESE COUNTERFEITERS TO SELL TO U.S. CONSUMERS



Source: redpoints.com

Brand protection challenges in Chinese e-commerce platforms

The challenges in monitoring and controlling the spread of counterfeit goods on many of these platforms are significant. The sheer volume of transactions, coupled with the sophistication of counterfeiters who often exploit these platforms, limit the effectiveness of enforcement efforts.

82% of Chinese marketplace sellers processed by Red Points lack readily available seller information. This data gap impedes efforts to effectively cluster and gather seller intelligence, hindering the identification and disruption of repeat offenders and hidden networks.

Additionally, Red Points enforcement data reveals the extended timeframe required to address infringements hosted by international and local Chinese marketplaces. Compared to non-Chinese platforms, takedown processes for Chinese platforms take 25% longer on average. These and many other references highlight not only the escalating issue of counterfeit goods shipped from China but also the challenges associated with effectively managing and mitigating these infringements.

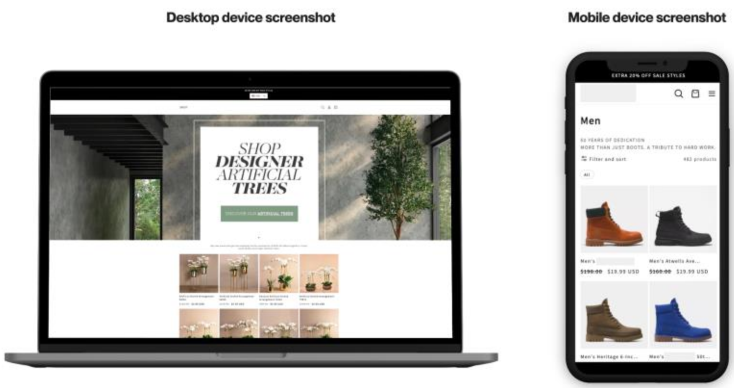
Section 4: Circumvention techniques used by Chinese counterfeiters

Continuously adapting evasion strategies

As we delve deeper into the impact of Chinese intellectual property infringing sellers, it is important to bring awareness to some of the common circumvention techniques used by counterfeiters.

With the help of technology, scammers devise increasingly sophisticated methods to sell counterfeit goods undetected. Even though these methods change rapidly, we believe a few examples can help us understand how scammers find their way to U.S. consumers in today's digital world.

- Mobile-only counterfeit shops: To cloak their digital footprint, many are building e-shops that are only available through mobile networks or when the user agent represents a mobile device, but shows harmless, unrelated content when accessed through a desktop browser. This tactic creates a facade of legitimacy, lulling unsuspecting consumers who are typically drawn to such websites via volatile social media ads.



- Hidden auctions: Marketplace listings can show generic products but conceal the actual counterfeit goods, allowing consumers to connect the dots through social media content or private messages, further complicating online detection and enforcement by rights holders.

- Social media-first user acquisition: A growing concern is the increasing prevalence of cross-channel distribution. Sellers initiate engagement and promotion on social media platforms like TikTok, Meta, and Reddit, and then redirect consumers to marketplaces or standalone websites for transactions. This creates a complex web of activity, hindering brand protection efforts.

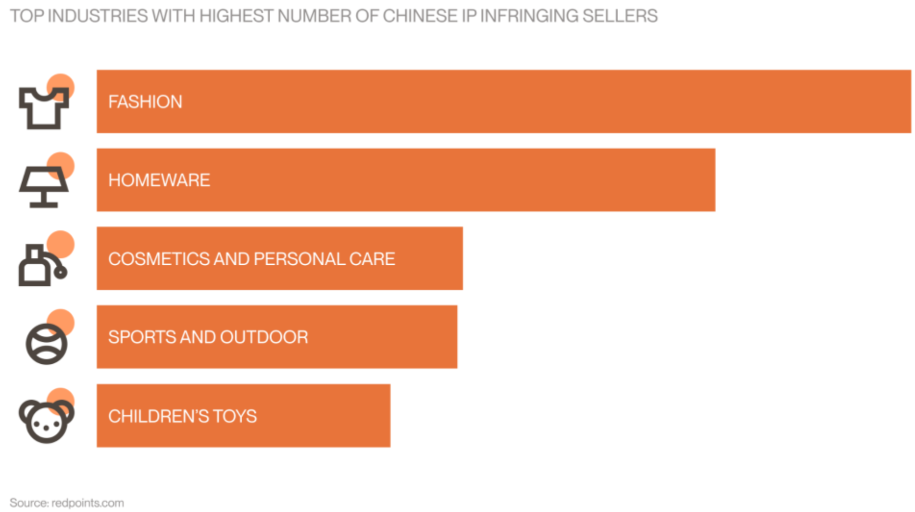
- Misspellings: To further evade detection, sellers weaponize obfuscation through extensive misspellings and generic keywords. Our data reveals almost 90,000 variations of Chinese search keyword suggestions annually including misspellings, masking, and disguising counterfeit listings.

- Wrong category: Another deceptive technique used by malicious online sellers involves misclassifying their product listings under irrelevant categories. This intentional misrepresentation is designed to evade detection by online marketplaces' monitoring systems, further complicating the challenge of combating the sale of counterfeit goods on their platforms.

Section 5: Safety and economic threats of counterfeiting to U.S. consumers and businesses

Industries most impacted by Chinese counterfeits

In our efforts to help brands fight back against Chinese counterfeiters, we have identified several industries where counterfeit products are most prevalent. These include fashion, homeware, cosmetics and personal care, sports and outdoor, and children's toys.



The proliferation of counterfeit goods in these sectors engenders significant health and safety concerns for consumers. For instance, in the fashion industry, there is a troubling lack of clarity regarding the chemicals used in the production of counterfeited items like jeans or underwear, which potentially harm both manufacturers and wearers. In the realm of homeware, questions linger about whether the materials used in these counterfeit products adhere to food and health safety standards. The cosmetics and personal care sector faces uncertainties about the ingredients in counterfeit beauty products and the potential dangers these unknown chemicals might inflict when absorbed by the skin. In the sports and outdoors category, concerns surround the safety of counterfeit electronic equipment, such as muscle recovery devices, which might carry the risk of electrocution. Furthermore, the children's toy industry confronts grave risks, particularly from counterfeit products like infant car seats or teething rings, which often contain hazardous substances. These counterfeit products pose significant dangers to children's health and safety, including the presence of toxic chemicals or paints, choking hazards, and even failure of primary safety restraints.

Beyond these industries, similar health risks are present in nearly every other sector, such as Consumer Packaged Goods, which include everyday items like health supplements, chocolate, soda, or toothpaste, or electronics and spare parts of machinery. Aircraft components, automotive parts, chemicals for the farming industry, or industrial equipment are all targets for counterfeit manufacturers and distributors. Red Points' experience in supporting hundreds of corporate customers exposes how virtually no industry remains immune to these threats.

Economic and brand implications for U.S. companies: A high price to pay

Beyond the impact on safety, counterfeit products present a multitude of threats to legitimate businesses across the U.S., encompassing far-reaching economic and reputation implications. As per the February 2020 USPTO Counterfeit Report, U.S. businesses lose more than $200 billion annually to counterfeiting and piracy. This economic impact is compounded by the loss of over 750,000 jobs[11], highlighting the significant detriment to the workforce and economy.

Further estimates from the same report suggest that the sale of counterfeit and pirated goods abroad directly undermines the U.S. market, with the displacement of genuine sales by counterfeit goods costing

[11] Bharadwaj, V. P., Marieke Brock, Bridey Heing, Ramon Miro, and Noor Mukarram. 2020. "U.S. Intellectual Property and Counterfeit Goods—Landscape Review of Existing/Emerging Research." *Social Science Research Network*, January. https://doi.org/10.2139/ssrn.3577710.

the U.S. economy approximately $29 billion every year. This displacement not only affects business profitability but also has broader economic consequences.

Moreover, counterfeit goods erode the value of legitimate brands. When brand owners lose the ability to command a price premium for their genuine branded goods, it results in diminished innovation. The incentive for brand owners to invest in new, innovative products decreases as the financial returns on such investments are eroded by counterfeit competition. This not only impacts the companies themselves but also stifles progress and advancement across various industries, ultimately affecting consumer choice and quality.

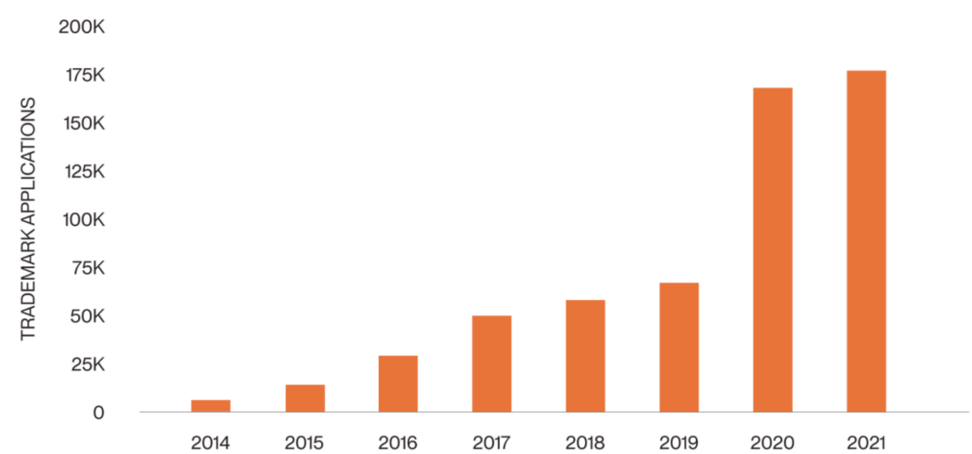
Section 6: Challenges faced by brands when combating Chinese intellectual property infringements

The importance of an appropriate rights registration strategy

As explained, while consumers undoubtedly face significant threats from Chinese intellectual property infringements, brands themselves grapple with formidable hurdles. Malicious intellectual property registration by Chinese parties poses a major challenge. In some cases, Chinese sellers actively file for patents and trademarks of U.S. companies through Chinese authorities, infringing upon the intellectual property rights of U.S. companies.

These actions not only create legal roadblocks for companies that want to start legitimate operations within the Chinese market, but they also make the enforcement of trademarks, patents, and other intellectual property rights a very complicated process, hardly affordable by small and medium businesses, and sometimes just technically not achievable.

USPTO'S PERFORMANCE AND ACCOUNTABILITY REPORT



Source: USPTO's Performance and Accountability Report

Further aggravating the problem is the issue of time sensitivity. Rapidly growing companies may inadvertently overlook or postpone securing their trademark registrations in China. This delay leaves them vulnerable to appropriation by others, potentially resulting in long-term damage to their brand integrity and market position within the fast-paced Chinese landscape.

Understanding and navigating local legislation is also a daunting task for many U.S. companies. Local marketplaces in China often give preferential treatment to Chinese intellectual property registrations, leaving U.S. companies with unregistered or pending intellectual property rights in China to assert their rights. This situation is further compounded by brand impersonation sites targeting U.S. shoppers perpetuating financial fraud and identity theft under the guise of legitimate brands. These sites create an additional layer of risk, not only constituting a blatant intellectual property infringement but also jeopardizing consumer trust and safety.

Section 7: Strategies for U.S. consumers to avoid Chinese counterfeits and safeguard intellectual property

Best practices for avoiding counterfeits as a consumer

Navigating the murky waters of online shopping to avoid getting fooled by Chinese counterfeiters can be challenging for U.S. consumers. Generally, consumers fall into two categories in this context:

- Unintentional Sufferers: These individuals hope to receive authentic products but later discover they have purchased counterfeits, often after contacting the legitimate brand's customer support center. The disappointment and financial loss experienced are significant, as they end up with products that may not meet their expectations, are unsafe, or simply do not adhere to the original's quality standards.

- Counterfeit Seekers: This group intentionally looks for cheaper alternatives to genuine products. For instance, they might want a Kansas City Chiefs jersey but are unwilling to pay the full price of $130 for an authentic one. Instead, they turn to marketplaces to find a similar jersey for a portion of the price, fully acknowledging that these are likely to be counterfeits.

While several authenticity technologies and devices are available, their effectiveness in the online shopping context is limited. Technologies like supply chain tagging and serialization are incredibly useful for verifying the authenticity of physical goods, but most of these tags and identifiers are not visible or verifiable through online marketplaces or social media sites. This limitation makes it difficult for consumers to ascertain the authenticity of products before purchase. The challenge, therefore, lies in discerning genuine products from counterfeits in an online environment where physical verification is not possible. Some valuable strategies can be applied to navigate this online landscape.

Firstly, it is crucial to cross-check product information with the official brand site for image similarity, misspellings, accuracy in details, specifications, and features. Gaining a thorough understanding of the product's features, materials, and specifications is vital to spot any red flags and discrepancies with the original item that may indicate a counterfeit.

For high-value purchases, such as mechanical or electronic equipment, verifying serial numbers with manufacturer databases is recommended. Products in listings where the brand name is misspelled or not mentioned are also red flag signs. Evaluating the brand logo for any discrepancies in shape, size, color, and design is another key step.

If there are doubts about a listing's authenticity, contacting the seller for additional information and specific details about the product is advisable. Legitimate sellers are usually willing to provide more information to build trust. Prices that seem too good to be true often are, so consumers should be cautious. Evaluating product packaging for any discrepancies, brand name misspellings, or poor-quality materials is important.

Investigating the seller's background, particularly on marketplaces, and looking out for customer reviews can provide insights into the product's authenticity, but paying attention to natural, human-like reviews only is paramount, as fake reviews can be generated by AI tools or purchased from shady service providers. Shopping on sites with friendly return policies is also advisable.

Checking whether the product comes with authentic high-quality packaging, including branding, holograms, and other security measures, can help determine authenticity. Ensuring that the product has the required certifications and trademarks owned by the brand is another safety measure. Using secure payment methods and avoiding less secure options like wire transfers is recommended.

Educating oneself and others about common scams and techniques used by counterfeiters can help avoid potential risks. Reporting suspicious products to the brand, marketplaces, or relevant authorities is also a crucial step in combating counterfeit trade. Finally, trusting one's instincts is essential; if any aspect of the purchase feels uncomfortable or suspicious, it's better to walk away.

Safeguarding intellectual property in China for U.S. companies

To effectively safeguard intellectual property from counterfeiters in general, and Chinese counterfeiters specifically, U.S. companies need a multifaceted approach.

As mentioned above, early and comprehensive intellectual property registration in China, especially given its 'first-to-file' system, is essential to protect intellectual property rights effectively.

Engaging experienced local counsel can provide invaluable insights into China's legal processes and cultural nuances. Additionally, for intellectual property disputes, considering alternative dispute resolution methods like mediation or arbitration, which can offer more cost-effective and quicker solutions compared to traditional litigation, might also be relevant.

Active monitoring of the market for potential intellectual property infringements and enforcing rights when necessary is critical. This could involve regular market surveys and the use of technology to proactively find online infringements. Furthermore, utilizing data mining capabilities can help prioritize brand protection strategies, plan legal actions against specific counterfeiters, and ultimately disrupt their networks. Litigation, for instance, can be effective in disrupting infringer operations by freezing their accounts and imposing financial penalties, which can help intellectual property rights owners not only recover revenue but also discourage repeat infringers from abusing their brand ever again.

Building strong relationships with local partners, authorities, and other stakeholders is equally important, as these relationships can facilitate a better understanding of the market and aid in enforcing intellectual property rights. Customizing contracts to align with local laws, incorporating robust confidentiality clauses, and educating employees about trade secret protection are crucial steps in safeguarding a company's intellectual property.

Lastly, when considering joint ventures with Chinese companies, thorough due diligence is vital. It's important to clearly define intellectual property rights in joint venture agreements to protect company interests.

This comprehensive strategy can help U.S. businesses navigate the complex intellectual property landscape in China and protect their brand assets.

Section 8: Red Points' recommendations for addressing the issue of counterfeit trade

Proposals for the Committee's consideration

As it has been widely stated, the proliferation of counterfeit goods in e-commerce poses a significant threat to U.S. consumers and businesses. To effectively address the issue of counterfeit goods from China, Red Points recommends a multi-faceted approach.

Firstly, mandating enhanced seller identification practices is crucial. This would require marketplaces and social media platforms to collect specific information that makes it easier to identify bad-faith actors, especially repeat infringers. This data should be at least partially accessible to consumers to provide them with the right level of visibility and empower them to make informed decisions. Establishing industry-wide authentication protocols and verifying adherence to them would further bolster this first line of defense against counterfeit infiltration. Facilitating swift identification and removal of counterfeit goods through such collaboration will disrupt their online presence and deter future attempts.

Secondly, implementing policies with stricter penalties for sellers repeatedly caught in the act would help dissuade repeat infringers and disrupt illicit networks.

Thirdly, for brands, it's essential to ensure that intellectual property rights are comprehensively registered to actively monitor the Internet for infringements of such rights. Engaging in enhanced collaboration with other rights holders strengthens enforcement efforts. Leveraging proven technologies like Artificial Intelligence (AI) and automation has proven remarkably helpful in identifying intellectual property infringements with greater speed and accuracy both for brands and for e-commerce platforms, but, whatever the solution, it should be encouraged to have a proactive system in place.

Finally, it would be beneficial to launch awareness campaigns to empower 'unintentional sufferers' and educate 'counterfeit seekers' on the dangers and negative consequences of purchasing counterfeit goods promoting responsible online shopping acts.

By fostering these interconnected strategies, we can forge a stronger and more effective framework to combat the proliferation of Chinese counterfeit goods in the U.S. market, thereby safeguarding businesses' brand integrity and consumer trust, and minimizing citizens' exposure to safety threats posed by counterfeits.

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OPENING STATEMENT OF DAN HARRIS, PARTNER, HARRIS-SLIWOSKI

COMMISSIONER GLAS: Thank you, Mr. Shapiro. Mr. Harris.

MR. HARRIS: Thank you. My name is Dan Harris. I'm a lawyer with 25 years' experience helping companies navigate China. Much of what I'll be discussing today is based on my own experience.

I have been asked to answer a number of questions related to China product safety. I address all of these questions in my written testimony, but today, I will be focusing on how China's legal and export insurance systems fail to prevent dangerous products from coming to the United States, in fact, to a large extent, they encourage that.

China's legal system does not provide sufficient recourse to American consumers harmed by defective Chinese products. Chinese companies often face no consequences for the harm caused by their products. This lack of recourse is not a big issue for Chinese companies that manufacture products for big companies like Walmart or Apple because those Chinese manufacturers typically prioritize keeping their customers happy. But this lack of recourse is a big issue for Chinese companies that sell to U.S. consumers via online shopping portals, or through small, U.S. retail stores.

Since around 2017, I've observed a decline in Chinese product quality and safety. I base this assertion mostly on the number of companies that have sought help from my law firm after having received such products and on the number of plaintiff's lawyers who have sought our law firm's help in pursuing Chinese manufacturers on behalf of their injured clients. And we probably take maybe 1 in 100 of those instances because usually it's hopeless.

Before 2017, I would have said that China product quality and safety had improved every year. I posit two main causes for this downshift in product safety. The first is that many Chinese factories are in financial trouble and there are three main reasons for this: one, COVID and its lockdowns; two, the decline in China's economy. I'm sure Mr. Miller can speak to that which has reduced domestic demand for Chinese products; and three, foreign companies moving their manufacturing out of China because of China's increasing risks.

Chinese companies with financial troubles often seek to reduce their costs by using lower-quality materials and components in their products. These lower-quality materials and components, in turn, increase the likelihood of defective or dangerous products. The second cause for the decline in product safety is that Chinese manufacturers see less value in maintaining long-term relationships with the American companies that buy their products and this is because they believe these companies are looking to leave China and they're probably right. I've had Chinese manufacturers tell me this.

With China's economy declining and American companies seeking China alternatives, we should expect the problem of unsafe Chinese products to worsen. Since injured American consumers typically cannot sue and collect damages from Chinese manufacturers, even consistently negligent Chinese manufacturers can continue operating. An American company that makes bad products usually must clean up its act or be sued into oblivion, but Chinese manufacturers lack any real incentive to improve product safety because they can continue operating and producing unsafe products.

Countless plaintiff product liability lawyers have contacted my law firm for help pursuing Chinese companies that sold dangerous products into the United States, ranging from explosive e-cigarette batteries to faulty skateboards and defective firecrackers.

Now, let's discuss Sinosure. Sinosure is a Chinese Government owned insurance company that protects Chinese exporters from nonpayment risk. I have been involved with close to 100 Sinosure matters. I almost always deal with Sinosure after it sends a threatening letter to an American company that has failed to pay one or more of its Chinese manufacturers. About 70 percent of the time, the American company failed to pay its Chinese manufacturer because the product it received was of poor quality or defective. The remaining 30 percent of the time, the American company failed to pay because it hit a financial rough patch or because the Chinese manufacturer flat-out lied about money owed it because it desperately needed the money from Sinosure.

In pursuing payment from American companies, Sinosure typically threatens legal action in the United States and in China. But Sinosure has never once sued any of our clients and that's because its most powerful and cheapest weapon is to prevent all Chinese-owned factories both in and outside China from selling products on credit to an American buyer that allegedly owes money to a Chinese factory.

We recently represented an American company that received around $300,000 of defective product from a Chinese manufacturer. The product was so bad that our client could not sell it at any price. Without seeking any explanation from the American company as to why it had not paid this $300,000 to its Chinese manufacturer, Sinosure paid the Chinese manufacturer 90 percent of the $300,000 and blocked the American company from buying more product on credit from any Chinese manufacturer. Because my client needed to buy a large amount of product from another Chinese manufacturer on credit, it had to pay Sinosure the full $300,000 for defective, unsellable product. Why should a Chinese company worry about product safety if it can get paid in full no matter how bad its products are, especially when it is at little to no risk of getting sued? This particular Sinosure case is typical and when you multiply it out thousands of times, you see the full extent of the problem.

For American companies with greater flexibility than the one in my example, we can employ various tactics to allow them to keep buying on credit from China without having to pay the factory or Sinosure, but American companies frequently find themselves with no choice but to pay Sinosure with what essentially amounts to ransom money. Thank you.

PREPARED STATEMENT OF DAN HARRIS, PARTNER, HARRIS-SLIWOSKI

March 1, 2024

Dan Harris

Attorney, Harris Sliwoski Law Firm

Testimony before the U.S.-China Economic and Security Review Commission

“Consumer Products from China: Safety, Regulations, and Supply Chains”

1. **What are the most critical issues facing U.S. companies in ensuring the quality and safety of goods manufactured or sourced from China?**

The most critical issues U.S. companies face in ensuring product quality and safety from their Chinese manufacturers are (1) selecting a reliable Chinese manufacturer, (2) drafting contracts that will be enforced against their Chinese manufacturers, and (3) conducting comprehensive Chinese factory inspections.

Selecting a reliable Chinese manufacturer: Identifying trustworthy manufacturers in China is difficult, due to the Chinese government's control over data access. China's counterespionage laws make conducting due diligence on Chinese companies potentially illegal, which in turn makes doing so fraught with risk.

In the past, any of my law firm’s lawyers or paralegals proficient in Chinese could access government records online to conduct due diligence on Chinese companies. Today, we must rely on an “approved” Chinese citizen within China (or who appears to be within China to the Chinese internet police) to perform this research, a change that adds time and complexity to the process.

Drafting Contracts that will be enforced against their Chinese manufacturer: In international manufacturing, the dual incentives of ongoing business and the threat of legal action ensure product quality and safety. In China, however, enforcement of legal judgments is challenging.

Enforcing a judgment or arbitration award against a Chinese manufacturer requires navigating China's court system. Chinese courts generally enforce breach of contract actions, but the effectiveness of such enforcement can vary, especially if the ruling could significantly impact the Chinese defendant or cause job losses.

Navigating these legal challenges requires China-specific contracts that account for the jurisdictional and enforcement realities in China. Foreign companies and their legal representatives must ensure their contracts are precise to avoid common pitfalls that could weaken their position in Chinese courts.

Conducting comprehensive Chinese factory inspections: Heightened risks and expenses related to traveling to China have led many businesses to reduce their direct visits to Chinese factories. Although using local quality control (QC) firms for routine inspections offers a partial solution, it reduces the level of direct control and understanding that comes from direct, first-hand inspections.

The impact of this reduction varies depending on the product. For buyers of simple products like t-shirts, the effect is probably minimal. But for those producing more complex and safety-critical products, such as airplane parts, the consequences of decreased direct oversight might be significant.

2. How frequently do Chinese producers fail to fulfill manufacturing contracts for U.S. companies?

In the last two years, I have had more American companies come to me with quality issues involving their Chinese suppliers than at any other similar period in the last decade. This trend in product quality issues likely results from China's economic downturn after the pandemic, along with the challenges American companies face in maintaining quality standards with Chinese manufacturers.

3. Why might Chinese manufacturers choose not to or otherwise fail to comply with contractual agreements?

The primary driver behind a manufacturer's decision not to adhere to contractual agreements is financial gain. To secure contracts and increase profits, Chinese manufacturers often overrepresent their production capabilities or resort to cost-cutting measures that compromise quality.

4. Are there any formal Chinese regulations ensuring or restricting U.S. firms' ability to conduct due diligence on factories and producers in China? Are there any informal barriers to conducting these checks? What options do U.S. firms have if they are denied access or otherwise unable to conduct due diligence checks on Chinese producers?

China's counter-espionage laws restrict due diligence efforts and complicate access to crucial Chinese government records. Informal barriers further exacerbate these challenges.

Chinese laws do not explicitly ban conducting due diligence on China companies, but doing so falls within a legal gray area. This legal ambiguity, coupled with the risk of inadvertently breaking laws, poses significant challenges for foreign companies attempting to conduct due diligence.

Given these complexities, U.S. firms must act carefully, balancing the need for thorough due diligence with the legal realities of operating in China. Engaging local experts and consultants who understand the intricacies of Chinese regulations and business practices is often an expensive but necessary step to mitigate risks and ensure successful business operations.

5. What remedies do U.S. firms and consumers have if they receive shipments of poor quality, unsafe, or defective goods from Chinese producers, both within the Chinese legal system and U.S. legal system?

Legal remedies for companies that receive defective products from their Chinese suppliers are available in both the Chinese and U.S. legal systems, though their effectiveness varies. Enforcing U.S. judgments in China is often impossible. For more on this, please see my responses to paragraphs 1 through 4 above.

For consumers, redress directly against Chinese manufacturers is limited. Though suing a U.S. wholesaler or retailer for a harmful Chinese made product can be a viable option, it rarely is economical to pursue legal action against Chinese producers due to the unlikely enforcement of U.S. judgments in China and the often low damages awarded by Chinese courts.

6. How effective are those remedies?

The effectiveness of legal remedies against Chinese companies for defective products that harm American consumers is low, and many Chinese companies exploit this.

I learn about these companies because I often get inquiries from personal injury lawyers around the country seeking my help to pursue a Chinese company whose products harmed their client.

A notable example involves a Chinese company that purchases e-cigarette batteries from Korea, deliberately mislabels them to misrepresent their usage as e-cigarette replacement batteries, and then sells them at a high markup to U.S. smoke shops. These unsuitable batteries have led to numerous explosions, causing consumer injuries. Despite receiving multiple calls regarding this issue, finding a resolution remains challenging due to financial, legal, and jurisdictional hurdles.

I have also seen this with Chinese companies that always make unsafe fireworks and skateboards, underscoring the systemic nature of this problem. The current legal framework offers minimal deterrents to such practices, highlighting a critical area for improvement in consumer protection against defective Chinese imports.

7. What role may Chinese export insurance companies like Sinosure play in supporting producers of defective Chinese goods? How may financial institutions like Sinosure impact U.S. firms, and to what extent do these export insurance companies contribute to poor manufacturing and product safety standards in China?

Sinosure primarily insures Chinese exporters against non-payment risks from international buyers, a role that becomes contentious when disputes over product quality arise. Sinosure's tactics in pursuing payments typically include threatening legal action in the United States and/or China, blacklisting the U.S. product buyer from purchasing on credit from China, and demanding payment for goods that were either defective or not delivered. These actions sometimes compel U.S. firms to pay for defective products. Because Chinese manufacturers are compensated no matter how bad their product, they are less motivated to adhere to quality and safety standards. Though Sinosure seeks to paint itself as an export insurance company, it is just another arm of the Chinese government tasked with advancing China's interests, with little regard for fairness.

The Commission is mandated to make policy recommendations to Congress based on its hearings and other research. What are your recommendations for Congressional action related to the topic of your testimony?

1. The United States should establish stricter safety standards for imported goods, especially high-risk products. It should also increase its monitoring of imported products to prevent unsafe products from entering the country

2. Provide additional resources for U.S. companies to better understand and navigate the Chinese legal and regulatory landscape.

3. Evaluate the legality of Sinosure's operations under WTO (World Trade Organization) guidelines, as its operations may be an improper government subsidy. It might also make sense for the United States to engage with other countries to ensure that Sinosure complies with international trade regulations.

PANEL I QUESTION AND ANSWER

COMMISSIONER GLAS: I want to thank you all for your sobering testimony. I'm going to recognize Commissioner Wessel.

COMMISSIONER WESSEL: Thank you all for being here and Ms. Murray, having been on the Hill for many years, thank you for all that PIRG does. You are a force for change and good and so thank you for what your organization has done over so many years.

A lot of questions here, but we have to narrow the aperture to the mandate of this Commission which is the U.S.-China Commission, not toy safety, et cetera. But it appears to me that one of the principal problems we have is China operates differently than most other countries that are shipping into the U.S. When we look at export controls and other issues, when we look at the recent outbound investment screening mechanism, there's a qualification as a country of concern.

I'd like each of your responses to should we simply designate China as a country of concern in commercial affairs, especially here, and apply different standards, different standards such that there is country of origin labeling that is traceable throughout the system, that there be adequate importer liability, even when we're talking about platforms that they be required to bond, insure, et cetera, and that be reachable under U.S. law.

We're talking about a volume of abuses here and a vector China that appears to be an outsized concern. Should we treat them differently and should we therefore have a scope of responses that is adequate?

Ms. Murray, do you want to start?

MS. MURRAY: Sure. Well, I can start with the fact like what I focus on are all consumer products that fall under the Consumer Product Safety Commission.

COMMISSIONER WESSEL: Right.

MS. MURRAY: There's about 15,000 of them and I looked at a lot of toys because that's what we were supposed to do.

I think that -- I can't speak to the trends over the years and whether factories in China have -- the quality has gone down. What I know is that because China is the source of about 79 percent of our toys that come into this country, it's an outsized problem, but the measures that we have to look at, okay, what is the percentage? We don't really haven't anything that necessarily supports the fact that China is -- or Chinese manufacturers are any more dangerous than any other country, except for the fact that they're such a big part of our marketplace. So if we could address problems with Chinese manufacturers and products coming in from China, then obviously, that would cover a huge proportion of not only the toy market, but all of the consumer product market.

COMMISSIONER WESSEL: And let me push back on that for a moment and I appreciate. But we have a lack of visibility. We have a lack of ability to inspect facilities in China. We have all the other comments that your colleagues have made and that you're well aware of. I understand that others are also creating problems in terms of toys and other products. But again, China's system is different. The ability to reach those who are engaging in bad acts and getting recompense of being able to sanction them, of being able to stop them from simply reincorporating under another name and shipping the product, again, we're a China Commission. I appreciate the fact that China is not the only problem here, but again, you said 79 percent. To me, that creates an aperture that requires a response.

MS. MURRAY: Yes, I would agree with that. I mean if you're responsible for 79 percent of anything, then you have a lot of responsibility. And it's very true that the United States doesn't have enough enforcement capability against either Chinese manufacturers or you know, I honestly look more at the U.S. companies, the U.S. importers, the distributors, the retailers here that don't care. They haven't vetted where the products are coming from. If they did, they didn't care. They don't investigate enough. And that's where the problem is.

And you're absolutely right. Transparency is a huge problem. And you mentioned the labeling, like I had somebody ask me if a product should be labeled better or -- if you're buying them online if it should be more transparent, I say yes, for sure. How many labels would a particular product have? It's like okay, this part is made in China. This part is made in Vietnam. This part is made in India. I don't know. So that might get kind of confusing, especially there is so much toy labeling that's already required and consumer products. I don't know that that helps a lot, especially if you're buying it online because again, you don't really know, you don't have the full view of what it is that you're buying until you actually get the product and it's not anything like what you wanted.

I would like to see more -- well, I would like to see more dedication from U.S. manufacturers, importers, distributors, and retailers to know who they're buying from. Know your customer, know who you're dealing with because that's where the United States can make a difference because we have enforcement authority over those. And it would certainly be nice if we strive to have more enforcement ability and just higher standards for companies in China as well as in other countries. I'm not an expert to know how to achieve that through the mechanisms that we have, but that would definitely help. It would help public safety.

COMMISSIONER WESSEL: I see my time has expired, but thank you.

COMMISSIONER GLAS: Commissioner Sims.

COMMISSIONER SIMS: Thank you all for your testimony today. You know, I was thinking about the labeling issue and this is where I'm coming at from a parent. I can't help it, but think about the prospect of my six-year-old little boy getting hurt by any toy, but something that's made in China and by bad actors. And so when I'm thinking about what I would want to see as a parent, the labeling thing is interesting to me, not so much just as a made in China, that's on a lot of things that we have, but is there something to be said potentially for a label from companies who have been found to have violated a law or sent a product that had to be recalled like that, something where there would be a requirement where there's a label on it that says -- I don't even know what it would exactly be, but from a company that has had X issues in the past, well, I'm not buying that if I see that on something. Is that something that would be beneficial? Is that something that's been explored at all?

MS. MURRAY: I'm not aware whether that has been explored. You're talking about like putting them in the penalty box kind of thing.

COMMISSIONER SIMS: Yes, whoever made that shark right there that's hurting little kids, I don't want to buy a product from that company and if I knew that that company had sold tens of thousands, hundreds of thousands, millions of toys in the United States that had to be recalled as a result of one of these problems, I would want to know that.

MS. MURRAY: Yes, I have not heard of that idea. I don't know whether it's realistic. I mean a lot of these companies, they have different companies. I mean they're an umbrella company and so you wouldn't even necessarily have transparency. If one of them was in the penalty box, but they have five subsidiaries that they can put it under.

And then Dan had touched on it, too. The issue is like with these international re-shipper warehouses, we don't even know where these products are coming from, whether they're coming from again, China, or any other country. So I would like to see more focus perhaps on that transparency because it doesn't matter where it's coming from, if you're selling me something and you won't tell me where it's coming from, I have a problem with that. And at least if I can say okay, it's coming from China or it's coming from India or it's coming from wherever, then I can make a decision. But if you're not telling me, I assume it's bad.

COMMISSIONER SIMS: I'm just trying to think of some type of mechanism that increases consumer awareness of the danger of exactly what you're talking about. Is there a mechanism that you could think of that would be beneficial in that regard?

MS. MURRAY: I'm not aware of anything. It's an interesting idea that you pose, but I don't know of anything.

COMMISSIONER SIMS: The other two of you, any ideas on that front?
Okay, go ahead, Mr. Harris.

MR. HARRIS: I'm sorry, that list bad companies but it's not terribly effective.
One thing I'd like to add regarding what Ms. Murray said is U.S. importers don't care. Well, in my experience nine times out of 10 when you see a bad Chinese manufacturer shipping in dangerous products, its U.S. importer is its cousin in California or New York.

COMMISSIONER SIMS: Right. Well, let's shift then to the legal mechanisms here. What specific policy changes could we make here in the United States that would make our legal recourse more robust?

MR. HARRIS: Unfortunately, you're looking at me because I'm the lawyer, but I'm a lawyer and not a policy person. But the problem really is China. China does not care. Counterfeits, fentanyl, harmful products. It knows what's going on. It does not care.
I believe that these other countries; Mexico, Vietnam, Pakistan, Thailand, countries like that, they care more about how the U.S. views them.

Other than essentially banning Chinese products, I don't really have any suggestion that I think would be powerful because we can talk about giving recourse for American consumers in the United States.

They could sue the company that has shipped in countless numbers of bad e-cigarette batteries in the United States, but that's not going to do anything because they will never be able to collect.

And the person who testified prior to our group, he talked about how there are 20 companies behind a lot of these companies. Ms. Murray said the same thing. We can name a Chinese company and then they'll just morph into a different Chinese company and we can't stop it. It will be too late when we find out.

COMMISSIONER SIMS: Thank you.

MS. MURRAY: I'd like to either add on to that, or the next question just real quick. You were talking about putting companies in the penalty box?

If the importers that are U.S. based and that we care about, or the distributors or the online platforms, if these companies here would have their own penalty box because a lot of times these products that I deal with, toys and other things, a lot of them are sold by one outlet here in the United States.

I mean, if I buy -- if I'm a company and I buy 10 products in a row and eight of them get recalled and the other two are counterfeit or whatever, I'm just going to stop doing business with them so it would be better for the retailers, which are the front line that the consumer deals with, to be able to make those business decisions about who they choose to buy from.

COMMISSIONER GLAS: Commissioner Schriver?

COMMISSIONER SCHRIVER: Thank you. Thank you to our witnesses. I'm really learning a lot. This is not my area of subject matter expertise, but I'm learning a lot from you all so thank you.

I wanted to pick up a point that Mr. Harris just made. The problem is really China and so the practice of trying to combat this on point case by case, manufacturer by manufacturer, seems not only time consuming and inefficient, but not getting at the problem.

So, as I said to the first witness on the first panel, we know they can exert tremendous control when they want to. If any of these products had anti-Xi Jinping slogans on them, you can bet that company would be shut down very swiftly. So if the problem is China, what are the thoughts on reaching for more blunt instruments and not on point?

We had a Commission recommendation two cycles ago about reviewing PNTR and the agreement that China made with the United States which, of course, was a very substantial bilateral document and all kinds of promises were made.

But the narrative even surrounding that went further and said China's entry into the WTO would create a pathway and process that a lot of this would be worked out for Chinese companies to be competitive in the global market place. They would have to be better actors.

So the first questions is any thoughts -- I'll address this to all three. On the blunter instruments like PNTR review that might be available, and are we at that point?

MR. HARRIS: Well, I feel almost like that's a political question but I definitely feel we are at that point. We are way past that point. China does not play fair and we need to do more about that.

It really is China because it seems like all these other countries are in total -- I realize that percentage-wise they don't even equal China, but they are not as problematic. In our law firm I would say probably 30 percent of our business involves countries other than China, but 99 percent of the problems involve China. We don't see these problems coming out of Mexico or Vietnam. Vietnam a little, but we don't even see them coming out of countries like Pakistan or Bangladesh.

COMMISSIONER SCHRIVER: Other two witnesses, thoughts on any blunter instruments?

MR. SHAPIRO: Yeah, thank you for the question. I don't know about instruments but I would suggest that, you know, when we think about what we do, it's just the protection of people from receiving counterfeit goods. In other words, we're taking down millions of listings annually. Those products are unsafe.

Separate from manufacturers that might be building their product overseas and adhering to regulations in the U.S., the criminal element of counterfeiting, or the criminal element of fentanyl, which Mr. Harris mentioned, these are crimes.

The approach in solving criminal activity is sort of different from solving for, I think, people who are manufacturing products without that volume. For us today, when I think about those toys, I always wonder when I hear people who have had tragedies with a product, I always default that my guess would be it wasn't an authentic product.

Not that someone couldn't have made a mistake in an authentic product. Sometimes it does happen. I often think because the packaging is identical, because the product looks identical, did you get harmed by the toy manufacturer or did you get harmed by a criminal? I don't know that we know the answer to that question.

MS. MURRAY: We would --

COMMISSIONER SCHRIVER: Ms. Murray.

MS. MURRAY: Oh, I'm sorry. We would like to see definitely some blunter instruments. If there is a way that the U.S. government can encourage or require better adherence to safety standards from Chinese manufacturers, that would be great. That would be fantastic.

I don't know what those are. The politics is not my area. But I think there are also blunter instruments that we could employ against the companies that we do regulate in this country; the retailers, the importers, the distributors. There's a lot more enforcement that could take place that isn't occurring right now and that's what we would welcome.

COMMISSIONER SCHRIVER: Thank you very much.

COMMISSIONER GLAS: Commissioner Price.

VICE CHAIR PRICE: Thank you.

Thank you all for your testimonies today. I want to go back to some of the recommendations. That's one of our most important jobs as we do a report at the end of the year.

So Ms. Murray, thank you very much for your very detailed description. We'll go back and look at some of those pieces of legislation that's in your materials.

But at one point, and it gets to what we were discussing in our first panel, you talk about more resources to the CPSC. What would that look like in your thinking?

MS. MURRAY: Well, as it relates to China, of course the CPSC works with Customs at the ports to inspect shipments, look when the paperwork isn't right or if there's just reason to think there's something wrong, but they don't have enough staff flat out. That would be the main thing as far as imports from China.

VICE CHAIR PRICE: Do you have any specifics like what they would need? Do they need to quadruple what they have? In terms of inspectors any thoughts in that area?

MS. MURRAY: Well, the information that we have is that CPSC's Office of Inspection, they only have -- they can only provide staffing for six percent of our ports, more than 300 ports of entry. A lot of times it's only one individual. You know, these cargo ships, I mean, they are coming in with tons of stuff and there's just not enough capacity so it would be resources.

It would be staffing primarily, as well as having a better means for testing on the ground in real time and setting things to the side that need to be looked at more. Because a lot of these things, like so many products have lead or other toxics and that can't be easily detected.

VICE CHAIR PRICE: Thank you.

Mr. Shapiro, in your recommendations, in your written recommendations, you talk about launching awareness campaigns and things like that. Do you see that as a job for organizations? Is that a government responsibility? How do you see that coming through?

MR. SHAPIRO: Well, awareness campaigns are critical, I think, to some degree because -- I was talking to a reporter just recently who was sharing with me the brand of an eye glass brand, that she's very interested in purchasing. I've been in this space 14 years. I do wear glasses but I've never heard of that brand.

The challenge is if there were counterfeits in that brand, you certainly couldn't find them, unless that brand is working with someone. The fact of the matter is there are so many brands in the world and there are brands that are counterfeited.

I think as I said in my testimony, I would assume that all of them are unsafe. There is something wrong with that product that it has an inherent risk to any consumer that buys it.

Informing our consumers, the American consumers, about being a little bit more skeptical, a little bit more thoughtful about what they buy, protecting the purchasing of this product by taking down the listing so they are not available for consumers is a critical component.

So for us, I think for consumers, we sort of rely on folks to help us identify what's not safe for us to have, and the counterfeit version of that product is what is not safe.

VICE CHAIR PRICE: So we rely on folks. Are we relying on the government? Would it be a listing some place in a government entity? How do you see this coming together?

MR. SHAPIRO: Well, again, because it's a criminal element, I would say this one thing. The penalty for selling millions of dollars of counterfeiting is extremely small. It's somewhere around three to six months if you were caught and prosecuted.

If you were selling fentanyl, it might be 15 years, but you could make more money today. I was speaking with an FBI agent in a particular seminar and today he said there's more margin in selling counterfeit products than there is in being a drug dealer for heroin or cocaine.

While heroin and cocaine and drugs are at the top of our mind, there is an enormous amount of money being made in the world of counterfeiting. We really need to address that. That may be more of a legislative issue but I bring that up as a possible solution.

VICE CHAIR PRICE: Mr. Harris, I think you stopped short in your spoken testimony of getting to the recommendations. They are in your written testimony. Anything you'd like to jump in?

MR. HARRIS: In listening to everyone, I come back to the idea of the importers. When it comes to something like forced labor, there are -- the onus is actually put on the importer. But for things like this, it isn't.

For things like illegal transshipping to avoid duties, there are big American companies that buy product that they know is from Thailand -- I'm sorry, that they know is from China but it says it's from Thailand and they avoid the duties and they can basically get off scot-free when that's discovered.

My only concern here is -- I'm not by any means the expert on this -- so often the importer is in cahoots with the Chinese company that's selling this so that is a problem. It probably should be -- there should be tougher requirements on the importers.

If it's going to be someone's cousin in California, they should have to -- and they are importing toys, they should have to post a $5 million bond or something like that.

VICE CHAIR PRICE: Thank you.

COMMISSIONER GLAS: Commissioner Miller?

COMMISSIONER MILLER: Thank you. Thank you to the panel for your testimony. I would like to ask you about the circumstances not as they are now, but under the potential scenario where U.S.—China relations deteriorate markedly in the future.

Are there protocols in place for tightening the regime should we have a much more serious breakdown in the U.S. China relationship, or would this be a matter of waiting for congress to step in and quickly change direction?

What I'm getting at is where is this administrative authority versus awaiting a change in Congressional direction as the relationship would deteriorate?

If there is not a plan in place, are there recommendations you might have in terms of how to look forward in a worse-case scenario at how we might put protocols in place in order to have the regime change should the relationship deteriorate as I've been describing? Perhaps Ms. Murray.

MS. MURRAY: I'll go first. Well, I don't have expertise in that area. What I would say -- I mean, it's bad enough now so if relations deteriorate further and things as far as product safety get worse, then God help us.

I mean, maybe it could come -- maybe if there were more efforts put on -- more scrutiny put on importers, especially those that are in cahoots with the Chinese manufacturer, that might be one way to address it.

I mean, it's just going to require -- it's going to require something that's happening at the ports, you know, like it was suggested perhaps bonds of certain companies. More scrutiny. I mean, there are just so many things.

Then the one thing I think we touched on very briefly, but if I order directly from a website, and I'm not even sure where it's based, and I don't know if the product is even coming from China, but say I did, okay? It comes in the mail and it doesn't go through -- it doesn't go through the ports.

It doesn't get inspected by Customs or the CPSC or anything. It just comes in my mailbox. Now, it may take three weeks but those kinds of products which we are seeing more and more of that kind of online shopping, there isn't that safety standard in the middle.

A lot of times people don't even know that they are actually ordering something from China or another country until they get the shipping notification. Well, gosh, why is it taking three weeks to get here? Oh, it's coming from overseas.

MR. HARRIS: Yeah. I think it's an $800 exemption for small items. That is very dangerous and should probably be eliminated.

In terms of blunt instruments, what should the U.S. do if things just keep getting worse? The answer is it should do a lot more, but the problem is the more the U.S. does, the more it's going to cost meaning that right now we get cheap imports from China.

I could say in an ideal world we get no product from China. That would solve all these problems but it would create a new problem which is where are we going to get the product from in the short term.

But I do think there should be government policies in place like what Australia has done, Japan has done, to encourage private -- to use a carrot-and-stick approach to encourage American businesses to do less with China. Now, we are doing it in some -- with respect to some products but maybe we should be doing it with respect to more.

COMMISSIONER MILLER: Let me follow up with you on that, Mr. Harris. We're talking about the due diligence regime. Everyone knows that this regime is deteriorating. Beijing knows it's deteriorating. Help us think through this. What leverage does the U.S. government have short of borrowing the import of Chinese products or awaiting some future era of true de-coupling to push back on Beijing or Chinese companies.

I think more importantly what leverage do U.S. firms have in pushing back against what we're seeing which is a real deterioration of the ability to do due diligence in China?

MR. HARRIS: Well, the leverage is that American companies are a lot less likely to send money to China or to buy Chinese companies, or invest in Chinese companies because of this inability to really know what is going on there.

The problem is that we Americans always assume that people and governments operate based on economics. I don't think that's true of the Chinese government. I think economics, yeah. A nice economy, that would be nice, but it's far more important that the CCP control everything that is going on and they consistently make the choice to favor control over money.

Those two things have always been in a tension with each other with China. But starting in around 2012, 2013 control won out.

COMMISSIONER MILLER: Thank you.

COMMISSIONER GLAS: Thank you all for your testimony. I actually have a question for all of you but I have to be selective with my time a little bit here.

You know, it's horrifying to read -- thank you, Ms. Murray, for all the work that your organization does. It's horrifying to read what penalties have been assessed when somebody has lost their life because a product has failed.

I'm reading the one claim from September 29, 2023, about BJs Wholesale Club, selling faulty air conditioning, and then the woman died. The civil settlement was $9 million.

Then there's other examples here, maybe $16 million penalties, all civil -- a lot of civil penalties. If I'm a parent buying a defective toy that ends up killing my child or compromising their health, I want someone to go to jail.

Right now this panel is confirming for me, and please let me know if I'm wrong, that we do not have any effective deterrents right now. We are sending a signal to China in desperate times, as their economy is slowing down, that we're really not going to do much about this that is effective.

We are also sending a message to importers who are facilitating some of these products we are not really holding you fully accountable, or magnifying from the CBP, CPSC standpoint because we have let those agencies not have the resources necessary to do their jobs which, again, is a signal to China and the rest of the world we're really not looking.

So what you're saying -- all of you are saying, there's cost on intellectual property, there's cost to human life. It's fueling the Chinese bad behavior. There's no way to hold those manufacturers accountable. It's horrifying. It's horrifying.

I was just thinking about this and I just want to see if you disagree with me. In the first panel CPSC talked about when something is tested and is in noncompliance and dangerous, these items are seized and destroyed.

I want to play out a logic model here because, Ms. Murray, you also noted about the international mail environment, people ordering packages, they arrive like a week later. If I'm playing out that logic model, when bulk shipments come in and CPSC has an inspector there to do the necessary testing and they find out -- they pull a sample, they send that sample off to go get tested.

It comes back as dangerous, they can destroy and seize the entire bulk shipment. But in the de minimis environment do we only seize and destroy one package?

Are we saying to the Chinese send your products this way to the United States because no one is really looking and there's not a lot that may be destroyed in this meaning our effective -- the deterrents that we currently do have, the tools that we already do have in the tool box, are easier without de minimis around.

It's still not as effective as it needs to be but am I wrong in my assessment here that de minimis makes this environment far more incredibly challenging and it's sending a signal to the Chinese that if you are wanting to send product to the United States that do not meet standards, this is a pretty good channel to do it.

MS. MURRAY: And all that is true. I don't know how you would attack one package at a time, especially with the prevalence of online shopping. The one thing I do want to mention is you talked about the penalties, the civil penalties, and if somebody has an injury or death or their house burns down.

A lot of the civil penalties come from failure to report like in the case of BJs. It's after something has happened and there hasn't traditionally been anything more than civil liability. I didn't put this in my testimony but I actually -- this is something I follow very closely is the CPSC just won criminal convictions for the first time ever against a company.

It was Gree U.S.A., which is a subsidiary of Gree in China. Two executive were found criminally guilty, liable, for manufacturing dehumidifiers that caused all kinds of fires. It was a problem that was known.

It went on for a number of years. The company was penalized on a civil penalty, but then the two top executives, the chief executive and then the chief administrative officer, were just found guilty in November for criminal liability, criminal convictions.

So the CPSC made a big deal of that and maybe put some fear in some people like, oh, gosh, we could actually not just pay out money because there's not enough money to pay for somebody's life but, you know, if it's my company, I could go to jail.

And one of the recommendation that we did make, though, was that we would like to see Congress pass the CAP Act that was proposed by Senator Welch which would increase those civil penalties. Right now the CAP is $17.5 million. So you kill a bunch of people and you don't report it, the CAP is $17.5 million.

COMMISSIONER GLAS: Thank you. I know I'm over on time. Any further quick comment?

MR. HARRIS: Well, I definitely agree with all that you have said. I'm just not sure that even big seizures, and you said this, too, are very effective, especially when a Chinese company that gets in trouble can just morph into a new Chinese company or get a new exporter or whatever. The problem is so multi-faceted.

One thing I should mention is it does seem like the EU has been more effective with their product safety than the United States. I always hesitate to say throw more money at something, but China has made me much less of a free-market capitalist because in order to fight back against them, we need a lot of help from the government.

COMMISSIONER GLAS: Thank you. I'm way over on time. My apologies to the fellow commissioners.

Commissioner Friedberg.

COMMISSIONER FRIEDBERG: Thank you very much. Thanks for your testimony.

Mr. Harris, you said something which strikes me as very important and also, which I'm inclined to believe is true, which is the problem is that China doesn't care. I wanted to ask some questions that relate to everyone but maybe I'll start with Mr. Harris.

Really three questions. What are the manifestations exactly of their not caring? How exactly do we know that they are not caring? What would -- could they do if they did care. And then, of course, there is this big policy question which maybe we won't talk about here, but what could the United States government do to make them care?

On the first question, the manifestations of not caring, are they not enforcing their own laws? Do they not have laws that they could enforce?

You made a comment in passing at the very beginning of your remarks which I think was to the effect that they are actually doing things -- the government of China is doing things that actively encourage some of this bad behavior. Could you elaborate on that?

MR. HARRIS: Yes. I think they are actively encouraging it because their entire legal system is set up and a lot of their laws are set up in such strange ways as to stymie foreign companies and foreign consumers from getting recourse.

The commissioner, I believe his name is Mr. Schneider -- he was on the screen here -- he said that if there was something that was derogatory about Xi on some of these products, they would be stopped like that, and that is exactly true. The same is true with respect to fentanyl and, to a great extent, it's also true with respect to counterfeits.

The problem is that China doesn't care much about the United States, but they do care about maintaining control, maintaining harmony in their own country, and going after a fentanyl manufacturer who is the brother of the mayor, or a counterfeit manufacturer who is the mayor, is not good for the Chinese government so it's just not going to happen.

COMMISSIONER FRIEDBERG: Just further on this point. Sinosure, which you've described, it seems that they have extraordinary power in China. Where does that come from? Are they a private company? How could they prevent other Chinese companies from doing business with U.S. counterparts?

MR. HARRIS: They have incredible power. A company like Sinosure, it's an insurance company, it's the Chinese government and their computers are tied in with all the Chinese manufacturers. They know when a product goes out, they know when somebody in the United States is 33 days late with payment, they -- and they have cameras that are probably in every single factory.

They're everywhere, they know -- you can't buy a loaf of bread without them knowing, because you're using WeChat and they monitor all of that. So, yes, they generally know what is going on.

COMMISSIONER FRIEDBERG: So it seems like Sinosure is, essentially, an instrument of Chinese -- government policy?

MR. HARRIS: A hundred percent, it is the Chinese government. And so, there was a matter where we have a client from England that was suing a broker -- not even a manufacturer, a broker -- for having defrauded it of $10,000,000 -- the lawsuit's going on in England -- and Sinosure paid that broker $5,000,000.

And I said to the Sinosure representative in the United States, why the heck did Sinosure do that? They're not even a manufacturer. And she said, well, they're worried about losing jobs, factory jobs. They're just paying the money out. They're not an insurance company, they're a government subsidy.

And one of the recommendations I made was, that it seems to me it's a violation of the WTO, but there are a lot of violations of the WTO that just keep happening.

COMMISSIONER FRIEDBERG: Okay, I think my time is up. One just very quick question, maybe, on the what could they do or would they do. You made the very interesting point that we don't have these same problems with Mexico, Vietnam, Pakistan -- what are those countries doing to deal with these problems? Why don't we have that problem with those countries?

MR. HARRIS: I think about that a lot with respect to Mexico. I think it's because companies in Mexico view -- are more like companies in the United States, they view it in their own interest not to do these things because they want to maintain good relations with American companies and with the United States.

It just doesn't happen, I don't know exactly why but -- I mean, you can come up with a lot of different reasons. I don't think it's necessarily inherent in culture, I don't think that at all, I think it's inherent in government.

COMMISSIONER FRIEDBERG: Thank you very much.

COMMISSIONER GLAS: Chairwoman Cleveland?

CHAIRMAN CLEVELAND: Thank you to each of our witnesses for very distinct perspectives. I'd like to follow up a little bit on what Commissioner Sims raised in terms of how do we develop awareness, and -- with regard to either hazardous, dangerous, or counterfeit goods, or as you've identified, Mr. Harris, the very process itself, which is dangerous.

Would it make any sense at all, in a campaign of awareness, to require any platform, any e-commerce platform, that distributed, marketed products that were made in China, to identify the manufacturing site, a point of contact -- even though we know that they can morph into something else -- and a generic warning of some sort, that any import that the consumer buys directly from a factory in China may not be subject to consumer safeguards, testing, procedures that would protect them from health and safety concerns? Would that offer any improvement in terms of consumer protection?

MS. MURRAY: I can address that. The short answer is yes. I mean, how would you require it of an online platform? Especially if it's one that falls -- that doesn't fall with -- under the CPSC right now, because of the way that it's set up, if it's not a manufacturer, distributor, importer, or retailer?

But, yes, I think that would be fantastic, because that's how we get, you know, dehumidifiers that cause fires. I mean, right now, a lot of these companies in China, or other countries, they don't even comply with our U.S. safety standards like we've talked about. I mean, besides toys, you have hair dryers that are supposed to have standards, and if they come from China they may not.

There were a number of warnings that were put out last year by the CPSC about smoke detectors that didn't detect smoke, so that's a problem. So, yes, online warnings for these online platforms, all of them that operate in this country, that would be great.

CHAIRMAN CLEVELAND: Right, and I want this to be equal opportunity. I don't think that it's reasonable to require Amazon to have a flashing red warning sign for a product that Temu and Shein aren't also required to have if they desire market access, whether it's through de minimis or some other means.

Mr. Shapiro, I'm very interested in your discussion of, in your written statement, about challenges that brands face when combating intellectual property. And that you are seeing Chinese sellers actively file for patents and trademarks of U.S. companies through Chinese authorities, infringing on intellectual property rights. And then, you had some recommendations, I believe, on that matter.

Could you elaborate a little bit on what is happening in terms of, it's not just a question of a faulty, deficient, or mislabeled products that is counterfeit, we're now seeing legal action, and what might we do about that?

MR. SHAPIRO: Yes, both are very challenging, I think. Two things, in regards to trademark filing in China, they sort of have a first to file.

So, if you were a small entrepreneur in America, and you came up with a cool brand and you began to sell it, and perhaps you filed your trademark in U.S. and Europe and you began your business. And, all the sudden, you started seeing product on a marketplace, or on some sort of e-commerce site, where you saw your product at a very low price, we would assume it is a counterfeit item.

Now, what happens is we find out that there's someone operating in China with your trademark, and because you didn't file your trademark there it's actually not a counterfeit. Now, they're using your name, they may even use your exact logo, but it's no longer counterfeit because you don't have the rights in China.

Now, if they ship into the U.S., sometimes we can use a U.S. trademark to combat that product. The challenge for the brand owner is, how do we get that trademark back so that we can manage, you know, our business all over the place? And it can be challenging, it can be expensive to get that trademark back.

So, trademark squatting is a significant problem to IP owners, small and large. Certainly, they attack small entrepreneurs because it's easy, but they attack enterprise clients that -- you know, big brands all over the world, it's not just -- just not those small brands.

But, then, lastly I would say is that, I think from a challenge perspective -- I know of a lot of our clients, some of them have been in lawsuits over defective product. And some are fighting back and having the damaged product, that caused the harm, inspected only to find out it's not their product.

And so, in order to defend their livelihood and not pay out millions of dollars for something that they didn't do -- someone put their name and their packaging on that product and it harmed someone -- and so, therefore they have to spend resources, money, to say, hey, look, I understand you were harmed, but I've gone through the scientific evidence, that's not my product. You know, unfortunately, you purchased a counterfeit and we're not liable.

And I don't know if that directly answers your questions, Chairwoman.

CHAIRMAN CLEVELAND: It does, thank you. I'd like to follow up for the record, if I'm out of time, with Ms. Murray. Because, while we were focusing today on children's products, I'm very interested in the broader work that you do, and whether there are other priorities that present hazards and risks, as you identified with humidifiers and air conditioners. But I'll follow up for the record, unless we have more time or we have another round, so.

COMMISSIONER GLAS: Thank you so much, Chairwoman Cleveland, I know there's some interest. We do have a few minutes before we break, I know Commissioner Wessel had a question. And Commissioner Cleveland, I can also go back to you and anyone else.

COMMISSIONER WESSEL: I'd just make a quick comment. The situation of counterfeits, Motorcraft for example, was paying the warranty claims even though they were counterfeit, because they were worried about the degradation of their brand name. So -- and they appeared before us many years ago.

A quick question, I think. But, one idea we have discussed in the past is the question of requiring the importer of record to have sufficient bonding authority, sufficient insurance in place, to be able to recompense, compensate those who may have been injured.

Clearly, that has to extend to the platforms, etcetera. But, what that potentially does is also gives the insurance company the incentive to be able to go over and do the product liability, and the factory examinations, to know that they are charging a proper premium for the insurance. It's way of shifting to the private sector, if you will, or making more of a market-based approach to this, when CPSC and others can't investigate everything.

What would each of you think of that kind of idea, of expanding the importer of record approach in requiring them to have adequate insurance, which would be determined through legislation, etcetera, so that they're -- so that we shift the burden? Ms. Murray, quick response?

MS. MURRAY: I think that's an idea worth pursuing, particularly if it's products that have been a known problem in the past. I mean, whether we do that for every company, you have to have a bond. But, yeah, I think that idea could have some merit.

COMMISSIONER WESSEL: Mr. Shapiro?

MR. SHAPIRO: I think it's a challenge in the area in which I'm here to provide expertise in. In the world of counterfeits, this criminal element today that some people suggest it's around $4,500,000,000,000.

COMMISSIONER WESSEL: Right.

MR. SHAPIRO: Counterfeiters are criminals, they're not the product, and so their product looks like a legitimate brand owner. And so, if that product causes harm, we may assume the brand owner has caused the harm.

And I would tell you, in most cases -- I'm sure there's some shoddy brand owners, but I think the majority of the products that we buy that are defective, that cause harm to our persons, that ruin your laundry because you bought a shirt, I think they're counterfeit.

COMMISSIONER WESSEL: Yeah, but we have the Notorious Markets Report from USTR and a number of other things. If we had -- in my view, if we had this type of approach, the Amazons and the broader platforms are going to have a duty to investigate, including around counterfeits.

I'm not saying that there will not be slippage, but a lot of those counterfeits are coming through major platforms and broader approaches. If they have a duty to investigate because of the premium, it seems to me you'd be shifting the burden significantly. Yes, no?

MR. SHAPIRO: Yeah, I struggle with it only because I -- for me it's hard to understand. Because, if the product was labeled as a famous denim jean that you normally wear, we would assume that, if someone is selling that on Amazon, that it's the authentic version. If it turns out it's the inauthentic version, i.e. counterfeit, my question is -- I didn't know it wasn't the real one. I mean, so --

COMMISSIONER WESSEL: I don't mind making Amazon responsible for greater examination, through their website, of who their vendors are and whether they're engaging in, you know, appropriate sales. Mr. Harris?

MR. SHAPIRO: Yeah, I would -- may I just say a few --

COMMISSIONER WESSEL: Yeah, please.

MR. SHAPIRO: I do think transparency around the seller, right, the value proposition of marketplaces today is anonymity. So, that I could list an item that I no longer want and sell it to you, and you don't exactly know who I am, so you can't come throw rocks at my house. That's why it works, and it is also why we don't know who sold, you know, that item. And so, some greater transparency, particularly to offenders who have been on notice that your item has been counterfeit, maybe you lose some of those privileges of anonymity when you are a identified bad actor.

COMMISSIONER WESSEL: Okay. Mr. Harris, quick response?

MR. HARRIS: I think it's worth trying, I think it could work. It kind of makes me angry because it changes -- we're allowing China to essentially change the way we operate. And it's going to make it more expensive and more difficult for entrepreneurs and startups, because the costs will rise. But that's the world we're living in.

COMMISSIONER WESSEL: Understand. Thank you.

COMMISSIONER GLAS: Commissioner Cleveland?

CHAIRMAN CLEVELAND: Regrettably, that is the world we're living in, and -- yeah. Ms. Drake, this is for you, are there -- we have focused on toys, but do you think that there are other priority categories that we might focus some attention on as we go forward? Whether it's home products or some other category, are there risks that are in that 79 percent of the product comes from China that you might speak to?

MS. MURRAY: There are a number of product categories of things that come from China that are a concern beyond toys. I mean, a lot of it's children's sleepwear that's not protected for flammability, there's a ton of products that come from China that have lead, and phthalates, and other toxics.

I would say -- and I'm trying to think -- we actually have a big report coming out next week, called Safe At Home, and the answer is no. And I deal mostly with the actual products, not the counterfeits, and there are a number of disturbing trends that come from that. But, you know, a lot of the electrical products, because they don't comply with UL standards, those would be the product categories that I would be most concerned about, besides toys.

CHAIRMAN CLEVELAND: One of the points that I don't -- I think, Mr. Shapiro, you may have made in your written testimony, is that it has to do with inauthentic reviews and how that boosts sales.

Do you have any suggestions -- any of you -- on, in terms of, since we're focusing today, in part on Chinese e commerce platforms, how we might address -- because I read reviews carefully, but then, to read in testimony that they may not be accurate or authentic causes pause.

MR. SHAPIRO: Yeah, unfortunately sometimes people sell reviews online to other people, so it's a problem. But I do think, from a marketplace perspective and even a social media perspective, it is -- I think there are capabilities to manage whether or not a review came from an original product that was sold, as if -- or if it was just uploaded and added to a bunch of reviews.

And I think that is certainly something that can be managed, and managed better, with marketplaces and social media sites where it is capable of finding bad reviews, or fake reviews, that boost a product's landing on page one instead of page 20.

CHAIRMAN CLEVELAND: Well, of course this is what Google controls very very carefully. I'd appreciate your recommendations for the record on how we might go about considering that. Because, I think we tend to focus on the big platforms like Temu and Shein and Amazon, but I think social media platforms are now part of this problem, in terms of how they contribute to the distribution of unsafe and counterfeit goods. That's it for me right now. Commissioner Glas?

COMMISSIONER GLAS: Thank you. I know Commissioner Sims had a quick question, and that will round out this panel.

COMMISSIONER SIMS: Yes. So, it's really -- I have a comment, an observation, and then a joke which, if it's not appropriate, we'll chalk it up to this being my first hearing.

The observation is, I can't help but feel a sense of helplessness, in some regard, for like, addressing the size of this issue, and like, the lack of tools at our disposal to do it.

Comment is, Mr. Harris, you made a point that really resonated with me which is, my predisposition to being an unabashed free trader has been dramatically changed the more that I have dug into the U.S.-China relationship, and the value of, you know, tariffs and many other tools at our disposal to address some of these issues.

And one of the, kind of, fundamental tenants of, I think what our trade relation should -- relationship should be with China is reciprocity. And so, as Commissioner Schriver mentioned, the fact that if we had Xi Jinping, some negative CCP or negative Xi Jinping commentary on these toys or on these products, that they would get shut down immediately.

Which leads me to believe that, if we really want to stop China from sending toys into our country that are hurting and killing our children, we should just threaten to send, to flood the Chinese market, with Winnie the Pooh.

(Laughter.)

COMMISSIONER SIMS: Problem solved.

PARTICIPANT: They'd block it.

(Laughter.)

PARTICIPANT: They'd -- yeah.

COMMISSIONER SIMS: That's it, that's all I had to offer of value.

COMMISSIONER GLAS: Does anyone have a comment on Winnie the Pooh?

(Laughter.)

COMMISSIONER SIMS: Yes, exactly.

PARTICIPANT: Tigger.

COMMISSIONER GLAS: All right, I think that this ends this panel. Thank you all so much, we really appreciate your testimony and coming before the Commission. We will be following up with some questions in writing. And this Committee stands adjourned until 1:05. Thank you.

(Whereupon, the above entitled matter went off the record at 12:04 p.m. and resumed at 1:04 p.m.)

PANEL II INTRODUCTION BY COMMISSIONER KIMBERLY T. GLAS

COMMISSIONER GLAS: Our next panel will examine how shifts in global trade patterns affect U.S. supply chain resiliency, focusing on Chinese firms, moving manufacturing abroad as well as attempts by Chinese firms to circumvent U.S. tariffs via transshipment through intermediary countries.

We'll start with Dr. Edmund Malesky, Professor of Political Economy and Director of the Duke Center for International Development at Duke University.

He will evaluate the scope and drivers of Chinese firms moving manufacturing into Vietnam and will examine the consequences of Vietnam's evolving position within the U.S. supply chains for economic resilience.

Next, we'll hear from Dr. Rebecca Ray, Senior Academic Researcher at Boston University's Global Development Policy Center.

Dr. Ray will analyze investments by Chinese companies in Latin America and the Caribbean focusing primarily on the use of Mexico as a manufacturing hub to avoid U.S. tariffs. Finally, we will hear from Ms. Elizabeth Drake, Partner at Schagrin Associates.

She will evaluate the challenges to the U.S. from Chinese tactics to avoid or evade U.S. tariffs, including how Beijing may employ transnational subsidies to support below-cost manufacturing outside of China.

Thank you all very much for your testimony.

I would like to remind all of you -- all of our witnesses to please keep your remarks to seven minutes to preserve time for questions and answers.

Dr. Malesky, we'll begin with you.

OPENING STATEMENT OF EDMUND MALESKY, PROFESSOR OF POLITICAL ECONOMY AND DIRECTOR OF THE DUKE CENTER FOR INTERNATIONAL DEVELOPMENT, DUKE UNIVERSITY

DR. MALESKY: Thank you.

I sincerely thank Chair Robin Cleveland and Commissioner Kim Glas for the invitation to testify before this esteemed committee and share research on how international supply chains have adjusted to the U.S.-China trade war and the economic impact of those changes in Vietnam.

This is an extremely complex and data intensive topic and I've done my best to distill key findings that will be of interest to policy makers.

However, I'd like to emphasize that this is work in progress and some findings are preliminary.

In preparing this testimony, I'm indebted to the help of my co-authors who helped me prepare the analysis and data visualizations that I'm presenting here today.

Since the Trump Administration imposed tariffs on multiple Chinese export products in July of 2018, there's been a strong growth in Vietnamese bilateral exports to the United States as well as corresponding imports to Vietnam from China.

Noticing these trends, several analysts have sounded the alarm that the export surge has resulted in the rerouting of Chinese manufactured products through Vietnam.

Technically, rerouting can be defined as trade flows designed to evade origin specific tariffs by entering and exiting an intermediary country—essentially, sticking a Made in Vietnam sticker on pre-made Chinese products.

While some of the increase is certainly rerouting behavior by Chinese producers, the broader trend conflates this activity with three other patterns: the continuation of pre-tariff shifts in production caused by increasing Chinese wages and growing Vietnamese opportunities; two, immediate post-tariff increases in production by existing manufacturers in Vietnam; and three, post-tariff manufacturing investment and exporting by multinational companies of multiple origins.

In my written testimony, I've presented evidence for all three of these potential patterns before describing an ongoing joint research project to distinguish rerouting or relabeling behavior from the value-added investment that is also taking place and benefitting Vietnam.

In the first part of the analysis, I showed that the 2018 trade war resulted in higher levels of Vietnamese exports to the United States, predominantly driven by the shifting of supply chains into Vietnam.

Some of that shift, and it's really important to point this out, was already trending upward before the tariff in response to a more expensive business environment in China and growing opportunities in Vietnam.

However, there's still a noticeable upward change in trajectory after 2018. And that change is caused by two related activities.

First, the tariffs have led to increased production by firms with pre-existing affiliates in Vietnam.

Many foreign owned firms in Vietnam, especially Japanese, Korean, and Taiwanese firms employed what they called a China-Plus-One strategy.

These firms located most of their global value chains in China, but to address possible uncertainty, located some operations in Vietnam.

An immediate response to the tariffs, including hiring additional workers for new shifts without increasing new capital investment, and changes in export activity were observed immediately in the data.

Second, MNCs, multinational corporations in China, also began to increase new investment in Vietnam, building new factories as well as hiring new workers in the country.

As early as 2019, Japanese and Korean firms with operations in China began -- as well as Chinese companies began visiting Vietnam to consider investments there.

Some firms opened new factories and located higher valued elements of their supply chains in Vietnam.

These two activities were in response to the tariff and involved imports of Chinese raw materials, intermediate goods, and machinery.

But rather than simply relabeling the product, value was added before exporting to the United States.

Several analysts have found evidence for these patterns in the form of increased investment as well as higher employment wages and social benefits in Vietnam.

So, in my testimony, I go through and show many of these activities showing the shift of companies.

And I show, in particular, that after the COVID pandemic, the increase in multinational activity was predominantly driven by Korean manufacturers, but more staggeringly, Chinese companies.

The increase in Chinese firms was about 93 percent from 994 operations in 2017, to 1,920 operations in 2021.

They also had a significant impact on hiring.

Chinese firms increased their hiring by 60 -- by about 70 percent from 897,000 workers in 2021.

All right, so, to be clear, those trends are not evidence of rerouting. Only the shifting of supply chains and increased exports by affiliates.

So, in the second half of the written testimony, I present preliminary statistical work with co-authors.

This analysis is specifically aimed at identifying rerouting by conveying -- combining bill-of-lading or customs data with the Vietnamese enterprise survey.

We show that about 20 percent of Chinese firms and 8 percent of firms from other countries who invested in Vietnam after the imposure of tariffs are engaged in importing and exporting the same six-digit product.

These shares have increased over time and are correlated with the size of the tariffs.

According to our calculations, approximately 97 percent of the export value of electronic integrated circuits and 95 percent of computers are contributed by firms tagged as importing and exporting the same six-digit products.

Other impacted products include pumps, compressors, plastic floor products as well as printers and copiers.

One remaining puzzle that we've continued to work on is that tagged firms appear to be doing much more in Vietnam than simply relabeling.

These results are robust in numerous specifications and modeling choices.

Firms tagged as rerouters have much faster growth in employment and assets in Vietnam after the imposition of the tariffs than those importing and exporting different products.

And we spent some time thinking about why that might be in the data, why there actually is additional economic activity more than you would expect from simply relabeling.

These preliminary findings lead me to three recommendations.

First, exploration of rerouting behavior requires a much more precise and sophisticated analysis than is currently taking place in some policy circles.

Mischaracterizing legitimate investment and exporting behavior as rerouting could have negative consequences for the Vietnamese economy, undermining the strengthening economic relationship between Vietnam and the United States.

Second, our analysis points to some tentative evidence of rerouting, particularly by Chinese firms that newly invested in Vietnam after 2018.

If this can be definitively shown, countervailing measures against those particular exporters may be warranted.

However, before doing so, it would be beneficial to analyze how American workers and consumers may be benefitting from those same cheaper products.

And third, private domestic firms in Vietnam have not benefitted from the shifting investment landscape much at all. Most are too small and unconnected to global supply chains.

International assistance that can help Vietnamese domestic investors improve their productivity and provide intermediate goods and services to foreign investors would have a strong influence on economic growth and human development in the country.

Thank you very much.

PREPARED STATEMENT OF EDMUND MALESKY, PROFESSOR OF POLITICAL ECONOMY AND DIRECTOR OF THE DUKE CENTER FOR INTERNATIONAL DEVELOPMENT, DUKE UNIVERSITY

Testimony before the U.S.-China Economic and Security Commission
Hearing on "Consumer Products from China: Safety, Regulations, and Supply Chains"

Testimony by Edmund J. Malesky, Professor of Political Economy and Director of the Duke Center for International Development, Duke University

March 1, 2024

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I sincerely thank Chair Robin Cleveland and Commissioner Kim Glas for the invitation to testify before this esteemed committee and share preliminary research on how international supply chains have adjusted to the US-China Trade War and the economic impact of these changes on Vietnam. This is an extremely complex and data-intensive topic and I have done my best to distill key findings that will be of interest to policy-makers. In preparing this testimony, I am indebted to the help of my co-authors Ebehi Iyoha, Jaya Wen, Sung-Jun Wu, and Bo Feng, who worked tirelessly to help me prepare the analysis and data visualizations that I am presenting here today.

Since the Trump Administration imposed tariffs on multiple Chinese export products in July 2018, there has been strong growth in Vietnamese bilateral exports to the United States. Noticing this trend, several analysts have raised the alarm that the export surge has resulted in the re-routing of Chinese manufactured products through Vietnam. Technically re-routing can be defined as trade flows designed to evade origin-specific tariffs by entering and exiting an intermediary country, essentially sticking a "Made in Vietnam" sticker on premade Chinese products (Storey 2023).

While some of the increase is certainly re-routing behavior by Chinese producers, the broader trend conflates this activity with three other patterns: 1) the continuation of pre-tariff shifts in production caused by increasing Chinese wages and growing Vietnamese productivity; 2) immediate post-tariff increases in production by existing manufacturers in Vietnam; and 3) post-tariff manufacturing investment and exporting by multinational companies of multiple origins.

The latter two activities are also in response to the tariffs and may also involve imports of Chinese raw materials, intermediate goods, and machinery, but rather than simply re-labeling the product, value is added before exporting to the United States. Several analysts have found evidence for these patterns in the form of increased investment as well as higher employment, wages, and social benefits in Vietnam in the goods targeted by tariffs (Dang and Tran 2023, Malesky and Mosely 2021, Pham 2023, Rotunno et al. 2023, Wu 2023).

In today's testimony, I will present evidence for all three of these potential patterns before describing an ongoing joint-research project to distinguish re-routing/re-labeling behavior from the value-added re-routing that is also taking place and benefiting Vietnam (Iyoha et al. 2024).

In the first part of the testimony, I show that the 2018 trade war resulted in higher levels of Vietnamese exports to the United States, predominantly driven by the shifting of supply chains into Vietnam. Old investors expanded their investments and exporting activity while numerous new firms, especially from China, entered. These activities had visibly positive effects on Vietnamese wages, employment, and growth.

In the second part of the testimony, I draw on co-authored work to provide tentative evidence of re-routing: tariffs increased exports of tariffed products to the US and imports of tariffed products from China by firms based in Vietnam. Drilling deeper, we show that about 20% of Chinese firms and 8% of firms from other countries, who invested in Vietnam after the tariffs, are engaged in importing and exporting the same six-digit product. These shares have increased over time and are correlated with the size of tariffs. According to our calculations, approximately 97% of the export value of electronic integrated circuits and 95% of computers are contributed by firms tagged as importing and exporting the same products.

One remaining puzzle that we have continued to work on is that tagged firms appear to be doing much more in Vietnam than simply re-labeling Chinese imports and shipping them out. These results are robust to numerous specifications and modeling choices. Firms tagged as re-routers have much faster growth in employment and assets in Vietnam after the imposition of the tariffs than those importing and exporting different products. It may be that re-routing/re-labeling is a more expensive endeavor than it appears on paper, because value-added activity may be taking place at more fine-grained product levels than our data allow, or because re-routing is profitable allowing firms to finance other business activities.

Background

The US-China trade war commenced in February 2018 with the United States' imposition of tariffs on washing machines and solar panels. These products were chosen because the US International Trade Committee (ITC) determined that these imports had harmed US producers. The US then levied tariffs on steel and aluminum following conclusions from a US Department of Commerce investigation. Both sets of tariffs applied to multiple countries, however, then-President Donald Trump communicated that the ultimate target was China (Bown 2021).

The trade war grew more targeted, on June 15, 2018, when President Trump exerted his authority under Section 301 of the 1974 Trade Act to issue across-the-board retaliatory 10 percent tariffs on a wide range of Chinese products (Bown 2021). President Trump justified the tariff decision by arguing that China's sizable trade surplus with the United States was largely the result of unfair trade practices and currency manipulation. Throughout 2018 and 2019, the US levied five waves of tariffs on a variety of Chinese products. In response to each wave, China raised tariffs on its imports from the United States. In total, the US tariffs affected an estimated $350 billion worth of imports, and China's retaliatory tariffs targeted around $100 billion worth of U.S. exports (Fajgelbaum and Khandelwal, 2022). In 2020, the two countries signed an agreement that paused further tariff increases in exchange for a variety of concessions. However, the existing tariffs remained in place and have not been repealed as of February 2024.

Figure 1 reproduces Chad Bown's timeline of the trade war. Dates of initiatives are depicted on the x-axis with the average tariff rate applied to Chinese and US products on the y-axis. US tariffs on Chinese products are shown with a blue line while Chinese retaliatory tariffs are shown with a blue line. The dashed line shows that tariff rates to the rest of the world hardly budged over this time period.

Figure 1: Timeline and Scale of the US-China Trade War

Source: Bown (2021), Figure 1a

In Vietnam, these tariffs were greeted with marked enthusiasm, as some expected them to boost Vietnamese exports to the United States and further integrate Vietnamese companies into global value chains (Pham and Yeo 2018, Shira 2019). In the wake of the U.S. tariffs, Vietnam also significantly increased its exports to the United States. Total Vietnamese exports to the United States in April 2018 were $3.8 billion. By April 2019, exports had risen $5.1 billion, an impressive 25% year-on-year change. In the category of advanced technology products (ATP) – targeted especially by the Trump tariffs – the rise in Vietnam's exports was even more striking, from $642 million in April 2018 (nearly 17 percent of

Vietnamese exports to the US) to $1.4 billion in April 2019, a 120% increase (and 27 percent of total exports to the US). Importantly for our analysis below, ATP products affected by the Trump tariffs accounted for nearly 60% of the one-year post-tariff export increase.

The increase in Vietnamese exports to the United States sparked concerns about re-routing (Kitazeme 2019). Multiple scholars have pointed to the simultaneous increase in Vietnamese exports to the United States and imports from China as evidence of tariff-jumping behavior by Chinese firms. Robin Brooks, Managing Director and Chief Economist of the Institute of International Finance, for instance, presented ***Figure 2*** in an online debate on the *X* platform, highlighting the sharp upward simultaneous trajectory changes in Vietnam's trade deficit with China (blue line) and trade surplus with the United States (black line) after 2018 (shown by a gray dashed line). In a post accompanying the graph, Brooks wrote, "China circumvents US tariffs by sending stuff on more circuitous routes, primarily via Mexico, Vietnam, Thailand, and South Korea. There is no decoupling" (Brooks 2023).

While the circumstantial evidence is striking, the evidence presented is far from a smoking gun. First, it is quite clear from the graph that VN exports to the US were already surging after the US Bilateral Trade Agreement (USBTA) in 2001 and Vietnam's entry into the World Trade Organization in 2007 (McCaig and Pavnic 2018). At the same time, increasing growth in the Vietnamese market was leading to imports from China both as consumption goods, but also for construction materials and intermediate components in manufactured goods (McCaig and Pavnic 2-22). Indeed, the graph clearly shows that imports from China peaked in 2014 and did not return to that level into 2021.

Brooks' graph, however, does show a clear change in trajectory in 2018, indicating that while the pre-trends existed, they significantly accelerated after the tariffs. This slope change, however, does not necessarily imply re-routing and could be driven by two other behaviors that were also propelled by the 2018 tariffs.

Figure 2: Potential Macroeconomic Evidence of Re-Routing

Source: Brooks (2023) , https://twitter.com/robin_j_brooks/status/1726979556727533616

First, the tariffs may have led to increased production by firms with pre-existing affiliates in Vietnam. Many foreign-owned firms in Vietnam (especially Japanese, Korean, and Taiwanese firms) employed a China-Plus-One strategy. These firms located most of their global value chains in China but, to address possible uncertainty associated with China located some operations in Vietnam (Shira 2019). For the most part, the Vietnamese affiliates were involved in the less skill-intensive portions of the supply chain, engaging in either final assembly or providing the least technologically intensive inputs (Lam 2019). U.S. tariffs against Chinese products, however, offered opportunities to shift this balance toward Vietnam, enabling industrial upgrading (Amiti et al. 2019). An immediate response including hiring additional workers for new shifts without increasing new capital investment and the changes in exporting activity were observed immediately.

Second, MNCs in China also began to increase new investment in Vietnam building new factories as well as hiring new workers in the country. As early as 2019, Japanese and Korean firms with operations in China began visiting Vietnam to consider investments there (Shira 2019). Some MNCs opened new factories and located higher value-added elements of their supply chains in Vietnam (Lam 2019). Anecdotal evidence includes Taiwanese companies migrated to Vietnam to increase the production of tablets and smartphones as part of Apple's supply chain. At the same time, existing foreign investors, such as Samsung and Intel, deepened and expanded their operations. Foreign Investment Agency under the Ministry of Planning and Investment of Vietnam shows that pledged and disbursed foreign direct investment (FDI) in Vietnam achieved ten-year highs in 2019, immediately after the tariffs. The amount of FDI that was licensed to enter the country grew 7.2 percent (to $38 billion), including nearly 3,900 new projects. Of these approved FDI projects, new and existing investors disbursed $20.4 billion, which also represents a 7 percent increase. The ratio of disbursed to approved and pledged investments stood at 54 percent, one of the highest proportions during Vietnam's reform era. Notably, foreign investment in science and technology surged sharply, ranking among the fastest-growing sectors in the country's FDI attraction (VNA 2019). The surging foreign investment growth has continued after the tariffs with new highs reached in 2022 and 2023.

These two patterns are fundamentally different from re-routing, as they imply increased investment and labor market activity of the economic actors. With re-routing, a company simply imports the product into Vietnam and exports the same product out. No manufacturing labor or facilities are needed as this activity is simply a logistical exercise. Increasing investment in existing facilities and new investments, however, implies the hiring of new workers, the purchase or lease of business premises, and expenditures in manufacturing new products. Critically, these businesses are likely still connected to supply chains in China and may continue to import raw materials, intermediate goods, and potentially machinery from China for production, the imports and exports of the Vietnamese affiliates will be very different.

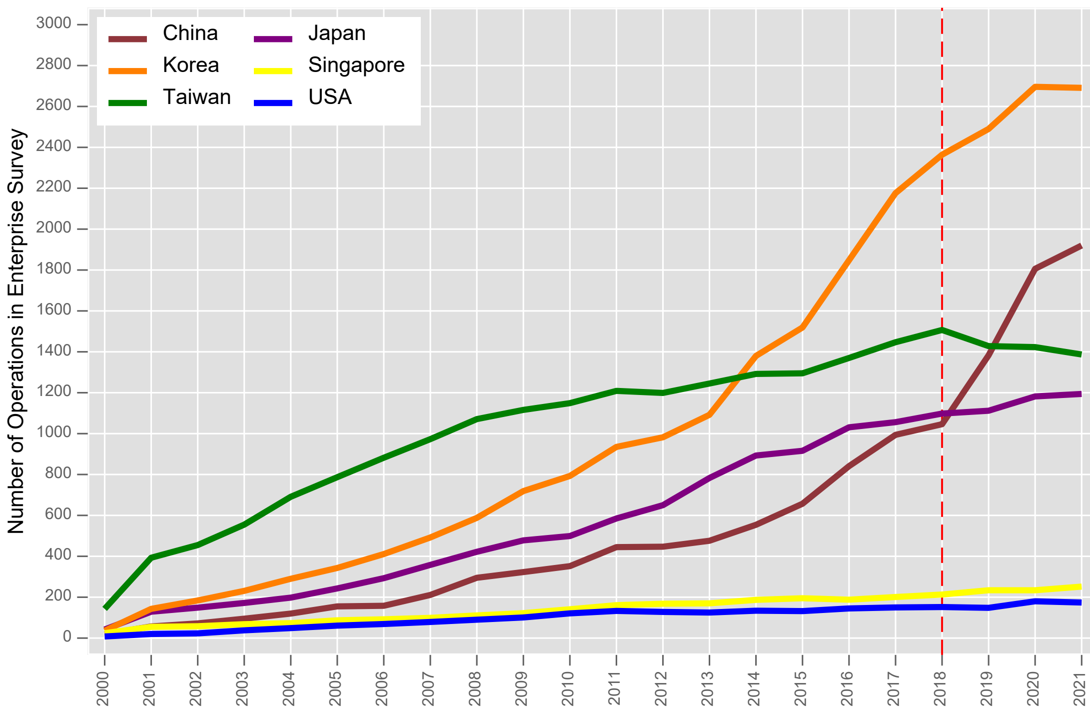
Differentiating these different patterns implies fine-grained microeconomic data on product-level imports and exports and customs offices and economic activity from tax authorities or investment surveys.

Shifting Foreign Investment: Expansion of Multinational Supply Chains

To illustrate the impact of shifting MNC supply chains, we use data from the Vietnam Enterprise Survey (VES), sometimes called the enterprise census due to its broad coverage of business activity in the country. The survey is conducted annually by the General Statistical Office (GSO), which sends surveys to all officially registered foreign and domestic businesses in the country and records data on firm ID, location, ISIC 4-digit industry classification, and balance sheet information. While the response rate is not perfect, especially for smaller firms, it offers the most comprehensive view of economic activity in the country. The 2021 dataset, for instance, includes over 800,000 domestic firms and over 14,000 foreign-invested businesses.

To conservatively measure MNC movements, we define a foreign firm by whether it sources 100% of its capital from abroad and assign the country of origin by the location of the company's dominant source of capital. Although it varies by year, over 60% of foreign manufacturing firms are engaged in exporting activity, compared to less than 5% of domestic manufacturers. In 2017, prior to the tariffs, mean employment in foreign firms was about 540 employees with $12.6 million in assets, however, there is a great deal of dispersion. The median employment (106 employees) and assets ($2 million) were much smaller, indicating a large number of small operations (Wu 2023). As others, have pointed out, foreign manufacturers dominate the export landscape, accounting for more than 50% of total manufacturing employment and sales and 70% of all manufactured exports (Wu 2023).

Figure 3: Post-Tariff Entry of Chinese MNCs is Greater Than Other Investors



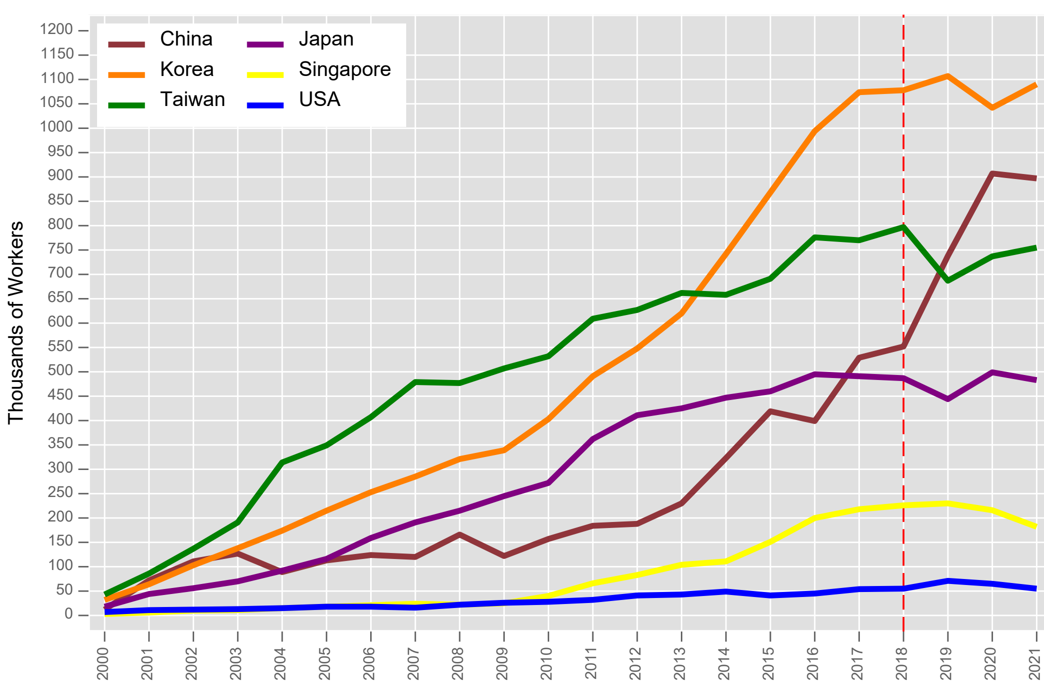
Source: Vietnam Economic Survey (2000-2021), General Statistical Office, Hanoi, Vietnam

Foreign Direct Investment (FDI) can be hard to measure due to challenges in whether the investment was simply licensed or actually disbursed and the share of foreign ownership necessary to count as an FDI. To avoid these definitional debates, ***Figure 3*** provides a simple count of the number of foreign firms in the VES operating in Vietnam at the time of the survey by country of origin. Again, we see a strong pre-tariff trend in investment activity in the country among companies from Korea, Taiwan, Japan, and China. In particular, Korean operations moved to Vietnam at a staggering rate, increasing their presence in the country nearly four-fold from 719 to 2691 operations, led by Samsung's dramatic investment in multiple products throughout the country. The rapid growth among most investor types declined after 2018, in part due to the difficulties of managing supply chains during COVID-19, with two exceptions. Korean MNCs continued to move into Vietnam, growing by 24% between 2017 and 2021. However, this activity was dwarfed by the number of Chinese businesses, which grew by 93% from 994 operations in 2017 to 1920 in 2021. This activity moved China from the fourth largest investor by number of operations (though not by capital size) in 2018 to the second largest investor in 2021.

Figure 4 shows that hiring by Chinese firms also increased after 2018 with total employment, expanding to 897,000 workers in 2021, a 69.6% increase over 2017. All other countries decreased or stagnated in total employment during this timeframe. There is very little change in the number of employees per operation for all countries, which ranges between 400 and 600 firms per operation. The employment growth appears to be entirely driven by new entrants. Increases in employment are consistent with other studies, which have demonstrated that the sectors exposed to the tariffs experienced increases in employment, wages, and social benefits for their Vietnamese workers, especially in products exposed to the tariffs (Wu 2023)

These findings are consistent with statistical evidence and public reports in Vietnam. Data from the Ministry of Planning and Investment's Foreign Investment Agency (FIA) showed China to be the top-ranked investor by number of projects in 2023 and the third-largest investor by capital size for every year between 2020 and 2023 with company's licensing between $2 and $3 billion in new investment capital each year. Included in these numbers are projects by Xiamen Lithium Energy Storage Technology ($900 million), Growatt New Energy ($300 million), and Shandong Metal Technology ($165 million), which are investing in batteries, energy storage, and precision tools in northern Vietnam. *Reuters* also reported that Chinese electronics, robotics, and home appliance firms were the top spenders on industrial leases in Vietnam in 2022 (Guarascio 2023).

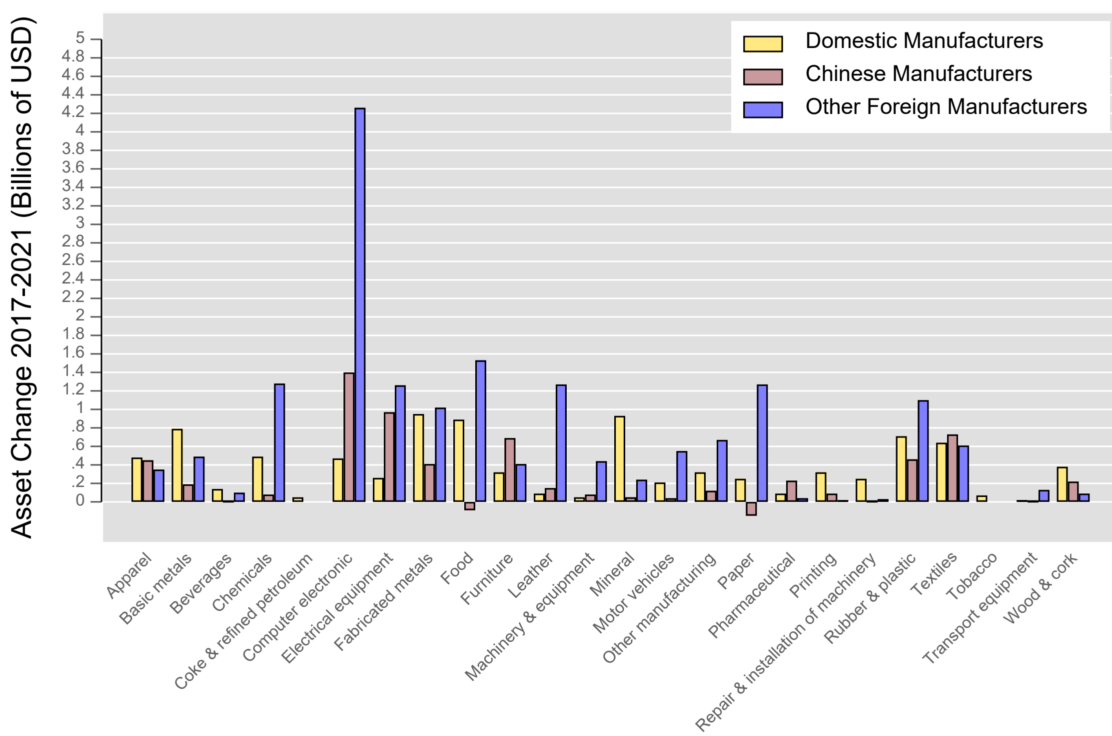
Figure 4: Post-Tariff Hiring of Chinese MNCs is Larger Than Other Investors



Source: Vietnam Economic Survey (2000-2021), General Statistical Office, Hanoi, Vietnam

Figure 5 highlights the impact of the tariffs by showing the industries where asset growth (as a proxy for investment size) was highest for Chinese, other foreign, and domestic investors was highest between 2017 and 2021. Although I don't show it here, we see similar patterns in terms of number of operations and employment size. Chinese operations were particularly active in entering and expanding the computer electronics, electrical equipment, garment, and furniture sectors. Other foreign investors expanded into computers and electronics as well, but were also active in food processing, rubber and plastics, paper, and chemicals production.

Figure 5: Computers and Electronic Equipment Are Most Impacted Products



Source: Vietnam Economic Survey (2017-2021), General Statistical Office, Hanoi, Vietnam

Tariff Jumping: Tentative Evidence on Re-Routing Behavior by Chinese and other MNCs

The above analysis has demonstrated that the 2018 trade war resulted in higher levels of Vietnamese exports to the United States, predominantly driven by the shifting of supply chains into Vietnam. Old investors expanded their investments and exporting activity while numerous new entrants entered. These activities had visibly positive effects on Vietnamese wages, employment, and growth. However, how much of this activity represents changing investment patterns and how much is the simple act of re-routing investment flows?

To answer this question, my co-authors and I turned to a more fine-grained analysis of transaction-level bill of lading trade data from S&P Global Panjiva. Bills of lading are legal documents that confirm when shipments reach their destinations. In Vietnam, they are regulated and collected by Vietnamese Customs. In addition, the dataset includes the unique shipment ID, the arrival date, the shipment value, the seller ID, the buyer ID, the shipper's country, the destination country, and the 6-digit harmonized system (HS) code, which indicates an extremely high level of precision on the specific products entering and exiting Vietnamese shores. Using the tax code, we match each of these products to the specific producer from the VES, allowing us to estimate the amount of economic activity in Vietnam that accompanies each transaction. We combine this with data from Bown (2021), which also records product-level exposure and average tariff rates to US tariffs at HS six-digit level.[1]

Figure 6 plots the results of our econometric exercise at the product level. The horizontal axis shows the number of quarters since the announcement of the tariffs in 2018 and 2019 (excluding the earlier general tariffs on steel and solar panels). The vertical axis can be interpreted as the difference in growth of exports to the US (or imports from China) relative to other trading partners, accounting for pre-period trends.[2] The green line represents estimated changes in US exports and the orange the estimated changes in Chinese imports with shaded bands depicting 95% confidence intervals around the estimates. Intervals that do not intersect zero on the y-axis are statistically significant estimates.

[1] One caveat is that we are limited to using six-digit codes to compare across countries. However, many of the tariffs were specified at an even more fine-grained HTS ten-digit level, targeting, for example, highly specific chemical compounds. In some cases, this meant that not every ten-digit product within a six-digit category was targeted by tariffs. To address, this we create two alternative measures that capture: 1) whether any product within a six-digit category was tariffed; and 2) the share of ten-digit products within a six-digit code that were tariffed.

[2] Because almost all goods in the "bills of lading" dataset are targeted for tariffs, we cannot compare targeted to non-targeted goods. Rather, the counterfactual in our analysis is the exporting and importing behavior in the targeted products to other trading partners. Our findings are substantively similar when we use the share of targeted products in each six-digit code, however, the counterfactual changes slightly as we are now capturing differences between targeted and untargeted products as well as trading partner.

We find clear evidence that tariffs (both measured discretely and continuously) strongly encouraged imports from China and exports to the United States compared to other countries. Before the tariff announcements, we see no differences in the exporting or importing of tariffed products. Exports and imports are as likely to go to the United States and from China respectively as other trading partners. Significant differences in the growth rates of exports of tariffed products to the United States and imports of tariffed products from China appear relatively quickly after the announcement of the tariffs and increase over time.

The execution of the China-Plus-One strategies can be observed in the time frame immediately after the tariff announcements. Firms that already had some presence in Vietnam, took advantage of existing facilities to increase production, likely by hiring additional workers and running additional shifts.[3] They did not have time to either import components from China or re-route tariffed goods from China. Within one quarter, we observe an immediate response in exports to the US. Growth in the exports of targeted products from Vietnam to the United States grew 0.3 log points or 30% faster than exports of those same products to other countries. Notice that in this initial period, there is not a corresponding response in imports from China, which does not appear until the third quarter.

Beginning one year after the tariff, we observe escalating differences in growth rates for both US exports and Chinese imports, interrupted by a sharp escalation during the 2020 COVID-19 shutdowns in China. By quarter 14, 3.5 years after the tariff announcement, we find that the tariffed exports to the United States grew 120% faster than to other countries, and imports of tariffed products from China grew 50% faster than other importing partners.

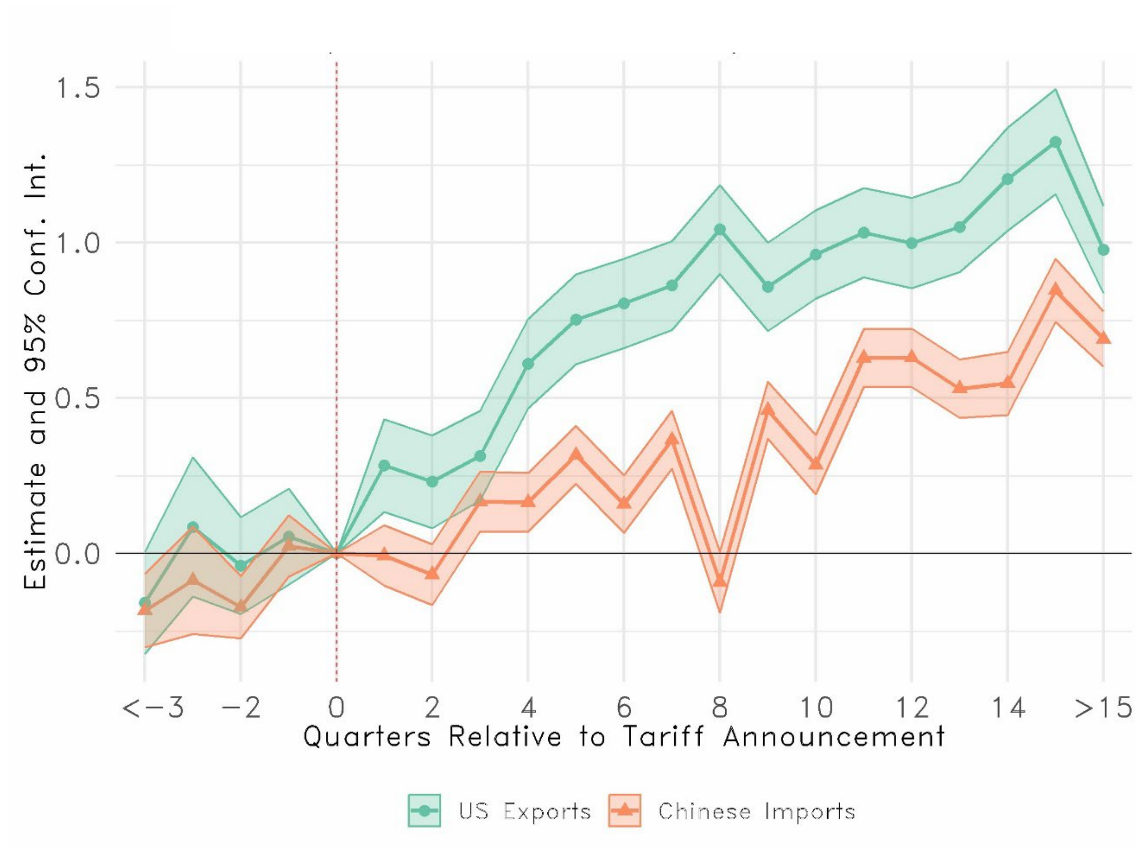
Figure 6 is not concrete evidence of rerouting, because it does not account for firm-level behaviors. Re-routing requires that the same firm is importing and exporting tariffed products without upgrading, but in Figure 6 different economic actors could be importing and exporting. Moreover, there is some level of imprecision because we matched data at the six-digit level. It is possible that upgrading could be taking place at the ten-digit level that is obscured by the aggregate data.

To address these issues, we combined the "bill of lading" data with the VES firm-level data. In a more rigorous test, we adapt our analysis to compare targeted and untargeted goods produced by the same firm, allowing us to perform a within-firm analysis that holds constant features of the firm, such as their country of origin, size, and location in Vietnam, which might have confounded previous estimates. We find similar results, though they are

[3] Only a small portion of the adjustment can be attributed to domestic firms. Most of the increase in exporting was performed by foreign MNCs.

understandably less pronounced.[4] Individual firms in Vietnam appeared to focus activities on targeted products rather than non-targeted products within the same operation.

Figure 6: Vietnamese Exports to the US and Imports to China of Targeted Products Grew Faster than with Other Trade Partners



Source: S&P Panjiva (2023). Estimated changes in targeted exports and imports to the US and China compared to the rest of the world.

Identification of Re-Routing Firms

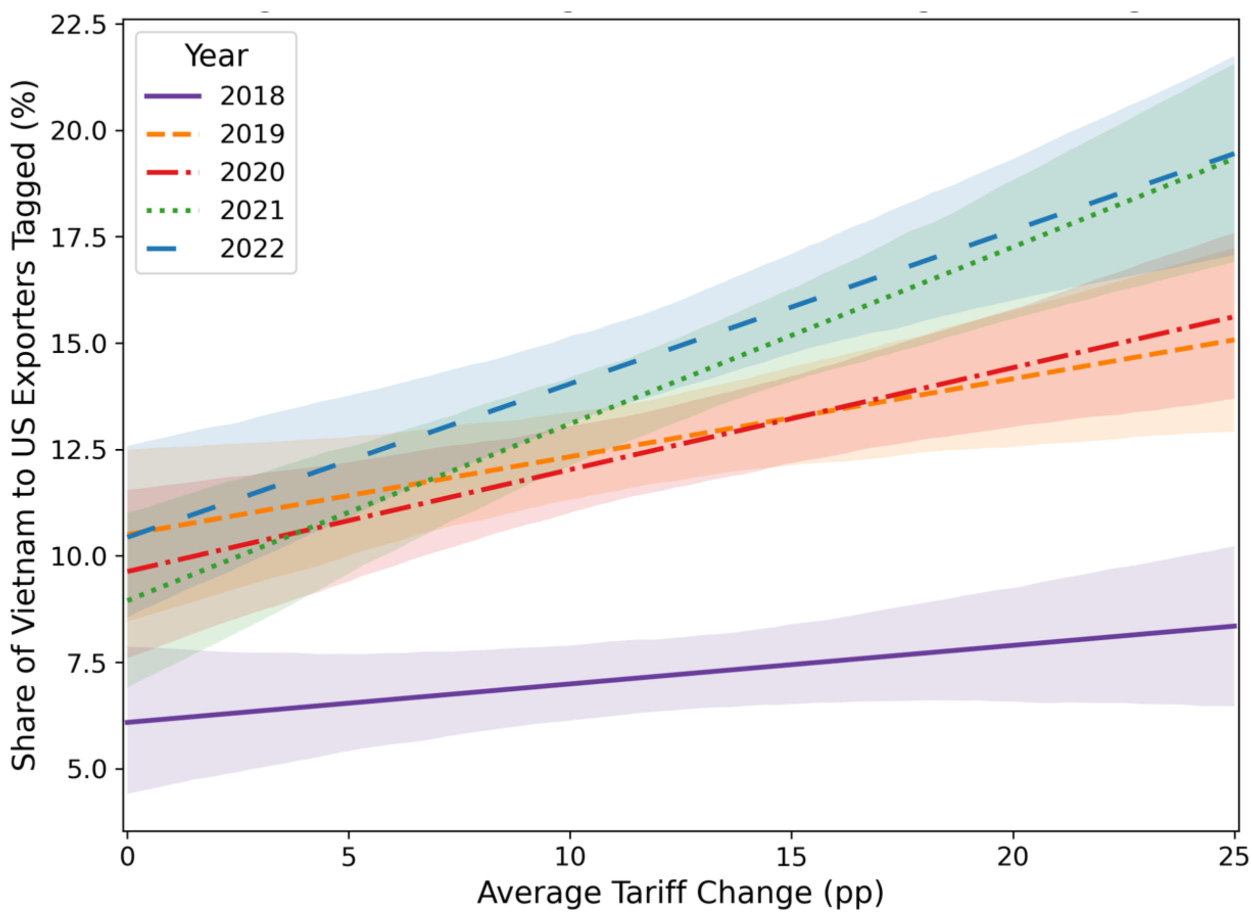
Even the firm analysis does not preclude the fact that entirely different businesses could be doing the importing and exporting of targeted products. Consequently, in our next analysis, we concentrate on the set of firms that are importing the exact same six-digit HS product from China that they are exporting to the United States, which we classify as tagged re-routers.

Figure 7 depicts the share of tagged re-routers among Vietnamese exporters over time in accordance with the tariff rate increase. As we might expect, the share of re-routers

[4] See Appendix A.

increases as the size of the tariff increases and this relationship increases over time, becoming steeper with each year. Re-routing behavior was relatively low and flat (about 6% of exporters) in 2018, but increased dramatically. By 2022, 12% of exporters at the 10% tariff rate increase level and 20% of exporters at the highest tariff rate hike of 25% are engaging in some re-routing.

Figure 7: Re-Routing Increasing over Time and with Average Tariff



Source: Vietnam Economic Survey (2017-2021) and Panjiva (2023). Re-routing coded at six-digit Harmonized Statistic level.

The bottom panel of ***Table 1*** presents the share of foreign exporters, who entered before or after the 2018 tariffs, potentially engaging in re-routing behavior before or after the 2018 tariffs. Re-routing behavior is highest among Chinese manufacturers. 20.2% of the sample that entered Vietnam after 2018 are tagged as re-routers, compared to 7.7% of firms from other foreign countries. This is likely an underestimate as not all shipped products can be matched to specific firms.

Table 1: Chinese Manufacturers Increase Re-Routing after 2018

All MNCs			
	Entered Before 2018	Entered in/after 2018	Total
Chinese Manufacturer	1,570	1,085	2,655
Other Foreign	8,028	2,451	10,479
Total	9,598	3,536	13,134
Number of Potentially Rerouting MNCs			
	Entered Before 2018	Entered in/after 2018	Total
Chinese Manufacturer	279	219	498
Other Foreign	1,043	188	1,231
Total	1,322	407	1,729
Share of Potentially Rerouting MNCs			
	Entered Before 2018	Entered in/after 2018	Total
Chinese Manufacturer	17.8%	20.2%	18.8%
Other Foreign	13.0%	7.7%	11.7%
Total	13.8%	11.5%	13.2%

Source: Vietnam Economic Survey (2017-2021) and S&P Panjiva (2023). Re-routing coded at six-digit HS level.

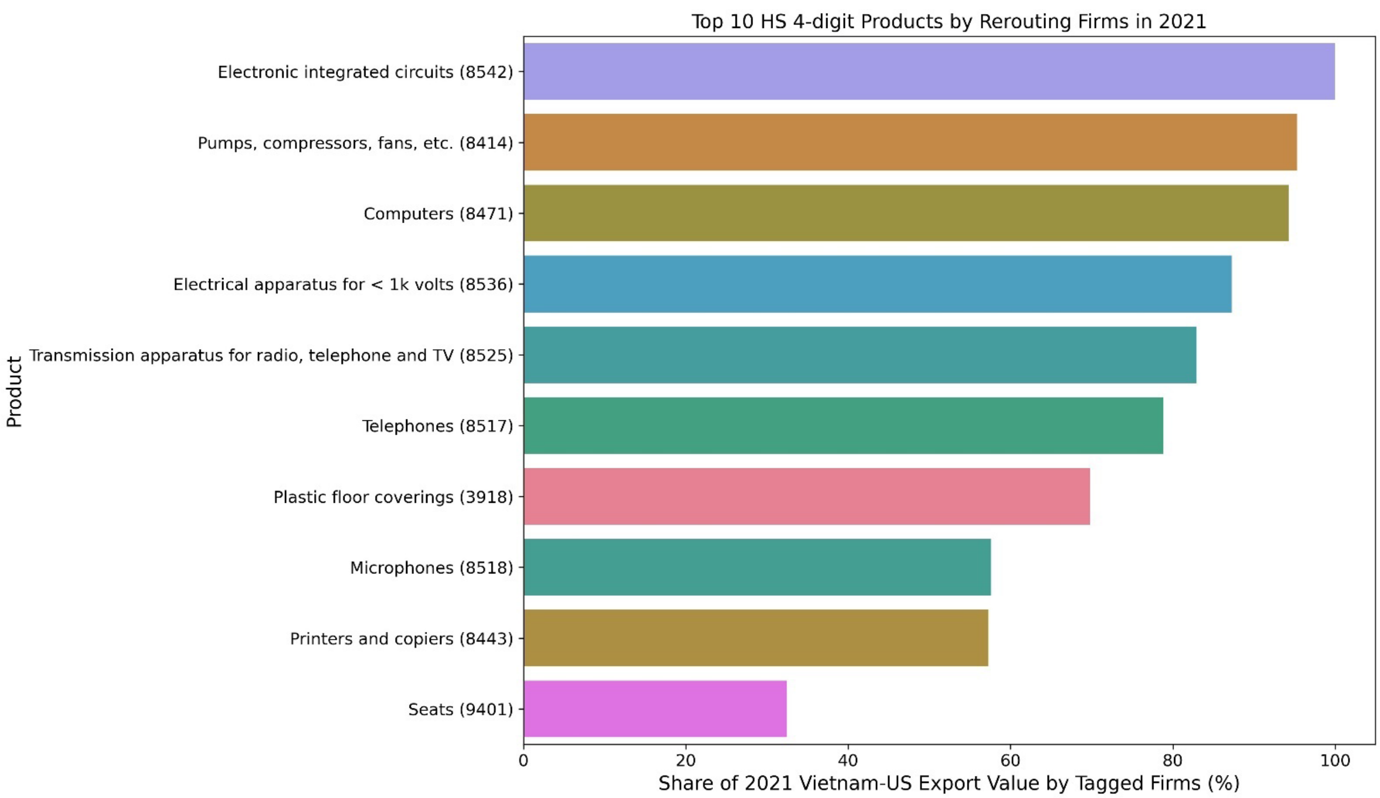
Figure 8 reports the top ten four-digit products for re-routing measured by the share of export value accounted for by tagged firms.[5] Electronics and computer products dominate the list. According to our calculations, approximately 97% of the export value of electronic integrated circuits was performed by firms tagged as importing and exporting the same four-digit products. 95% of the value of computer exporters also appeared to be accounted for by firms tagged as re-routing.

In a final econometric exercise, we find that tagged firms appear to be far more active investors in Vietnam than one would expect from simply re-labeling. In a differences-in-differences design that accounts for firm-level and industry-level confounders, we find that tagged firms increased their employment and assets by nearly 25% and 20% respectively

[5] For ease of presentation, we aggregate to the four-digit rather than six-digit level.

over firms importing and exporting different products.[6] This presents a final puzzle that deserves deeper exploration. It could be that re-routing requires additional employment and infrastructure or that value-added is taking place at a higher level of precision than our data allows us to identify. We continue to work on this question, though these preliminary results suggest that even re-routing behavior might yield positive dividends for the Vietnamese economy.

Figure 8: Top 10 Potential Re-Routing Sectors by Export Value



Source: Vietnam Economic Survey (2017-2021) and Panjiva (2023). Re-routing coded at four-digit Harmonized Statistic level for presentation.

Recommendations

First, exploration of re-routing behavior requires a much more precise and sophisticated analysis than is currently taking place in some policy circles. We recommend a more penetrating analysis into the shifting of investment into Vietnam based on high-quality product and firm-level data. Mischaracterizing legitimate investment and exporting behavior as re-routing could have negative consequences for the Vietnamese economy, undermining the strengthening economic relationship between Vietnam and the United

[6] See Appendices B and C

States. New investment caused by the US-China trade war has benefitted the country's economy and workers. Our analysis also shows that even re-routing investors may be benefitting the Vietnamese economy.

Second, our analysis points to some tentative evidence of re-routing, particularly by Chinese firms that newly invested in Vietnam after 2018 and among export goods with the highest tariff rates. If this can be definitively shown at the ten-digit product level, countervailing measures against those particular exporters may be warranted.

Third, private domestic Vietnamese firms have not benefited from the shifting investment landscape at all. Most are too small and unconnected to global supply chains. International assistance that can help domestic investors improve their productivity and provide intermediate goods and services to foreign investors would have a strong influence on economic growth and human development in the country.

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Appendix A: Within-Firm Adjustments of Exports to the US and Imports to China of Targeted Products Grew Faster than with Other Trade Partners

Source: S&P Panjiva (2023) and VES (2024). Estimated changes in targeted exports and imports to the US and China compared to the rest of the world by individual firms.

Appendix B: Employment Growth is Faster among Firms Tagged as Re-Routers after Tariff Imposition

	(1)	(2)	(3)	(4)
	logql	logql	logql	logql
Treatment*Post	0.319	0.371	1.782***	1.960***
	(1.087)	(1.087)	(0.312)	(0.339)
Year FE	No	Yes	Yes	Yes
Firm FE	No	No	Yes	Yes
Year*Industry FE	No	No	No	Yes
_cons	Yes	No	No	No
Observations	383026	383026	379201	378970
R^2	0.025	0.028	0.882	0.886

Sample is all firms who appeared in Panjiva and VES from 2015-2021.

Treatment is the average share of products rerouted in 2018-2021.

One standard deviation of the treatment is 0.016.

Post indicates whether the year is after 2017.

Standard errors are clustered at the 4-digit industry level.

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

Appendix C: Asset Growth is Faster among Firms Tagged as Re-Routers after Tariff Imposition

	(1) logasset	(2) logasset	(3) logasset	(4) logasset
Treatment*Post	10.576***	0.402	1.658***	1.588***
	(1.640)	(0.912)	(0.388)	(0.299)
Year FE	No	Yes	Yes	Yes
Firm FE	No	No	Yes	Yes
Year*Industry FE	No	No	No	Yes
_cons	Yes	No	No	No
Observations	338527	338527	333391	333143
R^2	0.037	0.756	0.965	0.968

Sample is all firms who appeared in Panjiva and VES from 2015-2021.

Treatment is the average share of products rerouted in 2018-2021.

One standard deviation of the treatment is 0.016.

Post indicates whether the year is after 2017.

Standard errors are clustered at the 4-digit industry level.

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

OPENING STATEMENT OF REBECCA RAY, SENIOR ACADEMIC RESEARCHER, BOSTON UNIVERSITY GLOBAL DEVELOPMENT POLICY CENTER

COMMISSIONER GLAS: Thank you.

Dr. Ray?

DR. RAY: Good afternoon, and thank you for the opportunity to testify.

I'd like to start by congratulating the Commission on an important and timely choice of topic.

Global supply chains are shifting, and now is an important time to consider the readiness of our policy frameworks for these changes.

Recent shifts in global value chains have come in part in reaction to the U.S.'s Section 301 tariffs on certain Chinese goods enacted in 2018.

The sectors covered by these tariffs also make up the majority of Mexican merchandise exports to the U.S.

So, it's reasonable to expect that Mexico may see increased Chinese investment and exports to the U.S. in these sectors as firms relocate to reduce costs.

Preliminary investment data reinforces this possibility.

As Table 1 in my written testimony shows, Chinese investment in Mexico's motor vehicle and electronic sectors have grown significantly since the tariffs took effect.

In fact, new data from 2023 shows that this trend has accelerated.

In 2023 alone, Chinese auto makers and truck makers announced more than $4 billion in new investment in Mexico, which is approximately as much as the entire previous decade of Mexican -- of Chinese investment in those sectors in Mexico.

Nonetheless, these new Chinese investments have not yet been reflected in increased Mexican-U.S. exports as Figure 2 shows in the written testimony.

Currently, no Chinese vehicle firms have their cars sold in the United States. However, some Chinese vehicle firms such as Foton and GAC have announced their hopes to expand into the U.S. market in the coming years.

So, before that happens, U.S. and Mexico have an opportunity to review the existing policy framework of the United States-Mexico-Canada agreement on trade, the USMCA, and ensure that it can manage any economic, social, or environmental risks that may come from increased Chinese investment in Mexico and any related exports to the U.S.

Mexico and the U.S. do not find ourselves in a new situation here, though. But rather one akin to returning to the years of 1994 to 2001, after NAFTA was enacted and before China joined the WTO.

In those years, Mexican exports to the U.S. soared in several sectors, including the those covered by the U.S.'s new tariffs, especially cargo trucks, vehicle parts, and some consumer electronics, as Figures 3 and 4 show.

Once China joined the WTO in late 2001, production shifted from Mexico to China for many of these export sectors.

So, the shifts the region is currently experiencing may be reminiscent of returning to the late 1990s.

Based on the Chinese investment trends in Table 1, and especially that rush of manufacturing invest in 2023, now is an important time to review the provisions of USMCA which replaced NAFTA in 2020 as it relates to vehicle trade in particular.

Fortunately, USMCA already strengthens protections along economic, social, and environmental fronts compared to NAFTA.

First, USMCA increased the regional value content, or RVC, rules.

While NAFTA required between 60 and 63 percent RVC for goods in the motor vehicle sector, USMCA increased it to between 65 and 75 percent RVC, dampening the potential for evasion relative to trade with other partners.

Furthermore, USMCA introduced labor value content.

Now, at least 40 percent of a vehicle's produced value must be made by workers earning at least $16 an hour.

Finally, USMCA brought labor and environment provisions in to the main agreement rather than side agreements, facilitating and strengthening enforcement.

Thus, USMCA provisions protect Mexican and U.S. economies, workers, and environments better than NAFTA did in the 1990s.

However, opportunities remain for continued strengthening of enforcement of these provisions.

Treaty dispute settlement is a cumbersome process, as the Commission knows. Primary labor and environment enforcement happen within each country's domestic institutions.

In this regard, it's important to note that the last decade of academic research, including by the Boston University Global Development Policy Center and our research partners throughout Latin America, shows that Chinese investors tend not to pressure host governments to lower or evade their labor and environment standards.

But they also don't tend to encourage them to strengthen those standards, either.

Instead, our research has found that host countries have considerable policy space, set and enforce their own standards without fear of losing Chinese investment.

Thus, in any investment boom like this one, it's crucial to ensure that institutional capacity is sufficient for the challenge of that enforcement.

The U.S. has several opportunities to bolster Mexican institutional capacity and ensure that this new Chinese investment and any coming Mexico-U.S. exports meet Mexican and U.S. policy goals.

First, the U.S. can lead by example by continuing to build the Partnership for Global Infrastructure and Investment, the PGI.

The PGI aims to coordinate G7 countries lending and investment strengths to bring high quality investment in crucial sectors to developing countries.

Well designed and operated investment through the PGI can raise expectations for performance of other international investors in Mexico.

Secondly, the U.S. can work with multilateral bodies like the Inter-American Development Bank to bring Chinese investors into established regional platforms rather than working alone to ensure investments adhere to the highest international standards.

When the IDB or its equity arm, IDB Invest, support a project, firms from all member countries, including the U.S. as well as China have an opportunity to bid on related work and projects themselves must meet some of the highest labor and environmental standards among development finance institutions globally.

President Biden and Treasury Secretary Yellen have stated their support for a capital increase at the IDB Invest.

U.S.'s formal support for this capital increase at the IDB's annual meeting this week can bring high quality investments to Mexico and also coordinated with those non-regional members like China for accountability.

Finally, the U.S. can continue to strengthen direct cooperation between the U.S. EPA and the Department of Labor with their Mexican counterparts.

EPA and DOL have a long and successful history of direct international cooperation. These avenues of mutual support are crucial for maintaining and building institutional capacity.

In short, now is an opportune time for the U.S. and Mexico to ensure that policy frameworks are attuned to the current shifts in global investment and trade.

And for the U.S. in particular to keep building up the PGI, work with regional bodies, and strengthen direct cooperation.

Thank you, again, for the opportunity to testify. I look forward to the discussion.

PREPARED STATEMENT OF REBECCA RAY, SENIOR ACADEMIC RESEARCHER, BOSTON UNIVERSITY GLOBAL DEVELOPMENT POLICY CENTER

Consumer Products from China: Safety, Regulations, and Supply Chains
Testimony before the U.S.-China Economic and Security Review Commission

Dr. Rebecca Ray
Senior Academic Researcher, Boston University Global Development Policy Center
March 1, 2024

Thank you for the opportunity to testify on the topic of shifting global supply chains and Chinese investment in Mexico. I congratulate the Commission on an important and timely choice of topic. The United States and Mexico have an opportunity to ensure that shifting investment patterns meet shared economic goals and social, environmental and transparency standards as outlined in the United States-Mexico-Canada Agreement (USMCA). My contribution aims to help the Commission plan effectively to meet these goals.

Key Points:

- Mexico may stand to benefit from the US tariffs on Chinese goods, as the targeted manufacturing sectors are crucial for Mexico's trade relations with the US. These exports, including motor vehicle and electronics, represent the majority of Mexican exports, making Mexico well positioned to receive more Chinese and Western investment as firms reposition themselves.

- The potential impact of US tariffs on value chains has not yet taken full effect: major changes in these sectors have not appeared in Mexico-US exports. Thus, the US and Mexico have an opportunity to consider potential risks and ensure that new investment meets social, environmental and transparency standards and does not undercut the commitments embedded in the USMCA.

- USMCA includes advances on labor, environment and transparency standards in regional trade and scholars broadly agree that strengthening enforcement of these standards remains a priority. This will be an important area for regional collaboration to manage changing investment patterns.

- The US can protect the standards of USMCA in three important ways. First, the US can lead by example in promoting high-quality investment through the Group of 7 (G7) Partnership for Global Infrastructure and Investment (PGI). Second, it can encourage Chinese investors to work through established regional multilateral investment platforms with embedded high-level standards, rather than working independently. Third, the US can continue to grow the regional cooperation efforts of the US

Department of Labor and the US Environmental Protection Agency with their Mexican counterparts. In these ways, the US can protect and advance its economic interests while ensuring trade with Mexico meets USMCA labor, environment and transparency standards.

1. Introduction

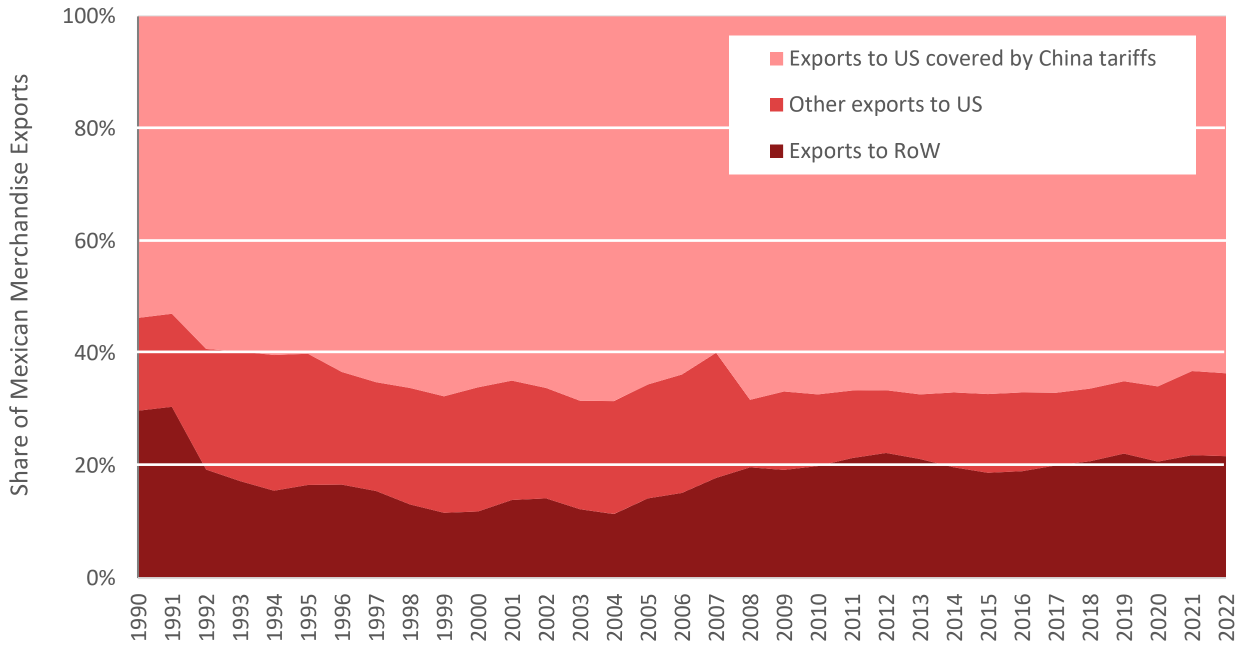
In 2018, the United States enacted a series of tariffs on Chinese products under Section 301 of the Trade Act of 1974, including tariffs between 7.5 percent and 25 percent on $370 billion in goods imported from China, or approximately two-thirds of the $563 billion imported from China in 2018 (UN Stats 2014). It is reasonable to expect these tariffs will result in changes in global value chains, with firms shifting production to third countries to avoid added expenses. In particular, Mexico may receive increased Chinese investment in the targeted sectors due to its proximity and history of free trade agreements with the US.

This testimony reviews these possibilities through three main sections. The first section explores trends in Mexico-US exports and anticipates potential future Chinese investment. The second section reviews the readiness of the United States-Mexico-Canada Agreement (USMCA) to address policy concerns that may arise from shifting value chains, especially labor, environmental and transparency performance by investors and enforcement by the Mexican state. Finally, the closing section presents evidence-based policy recommendations for the Commission's consideration.

2. Mexico-US Exports of Goods Targeted by China Tariffs

The goods targeted by US tariffs on Chinese goods are important sectors for Mexico-US exports. As Figure 1 shows, goods covered by these tariffs account for over 60 percent of overall Mexican merchandise exports as of 2022. However, their importance has not grown since the tariffs were enacted. Furthermore, as Figure 2 shows, Mexico-US exports account for less than 2 percent of global trade in these goods. Thus, any shifts in global supply chains through Mexico as a result of these tariffs has not yet taken effect. The next few years will be crucial for ensuring that the USMCA framework is capable of addressing economic, social and environmental concerns that may arise from future supply chain changes.

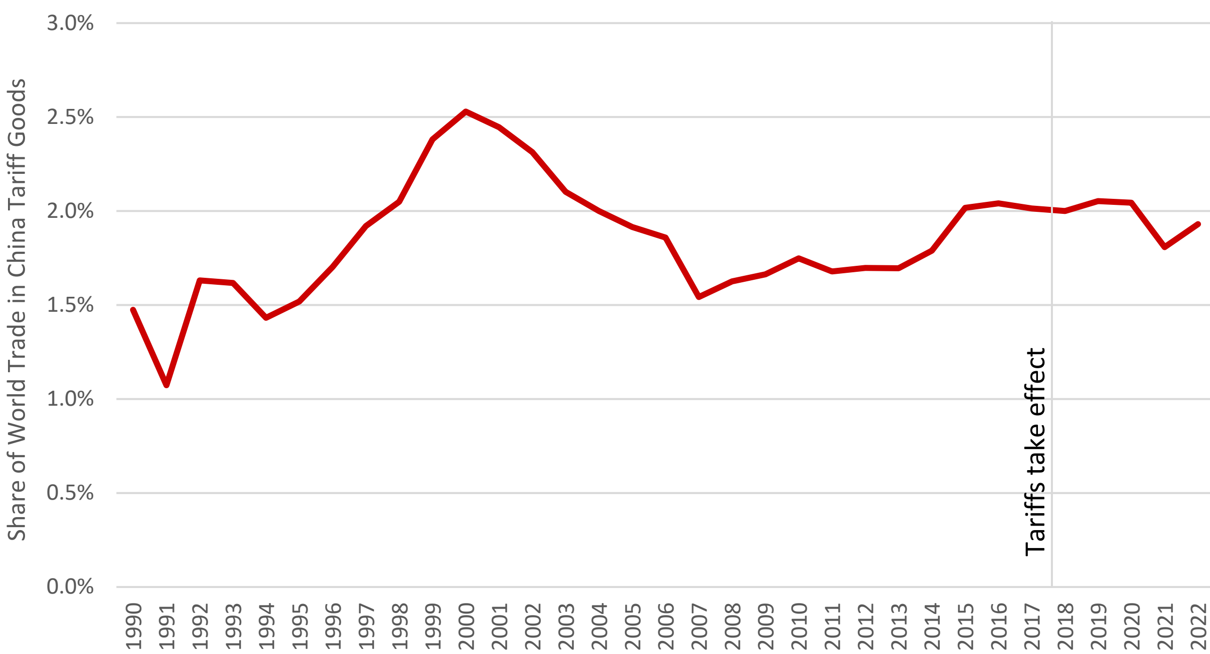
Figure 1: Item Categories Covered by China Tariffs as a Share of Mexico-US Exports



Note: RoW: Rest of world.

Source: Author compilation from UN Stats 2024 and USTR 2024.

Figure 2: Mexico-US Exports as a Share of World Trade in Goods Covered by China Tariffs

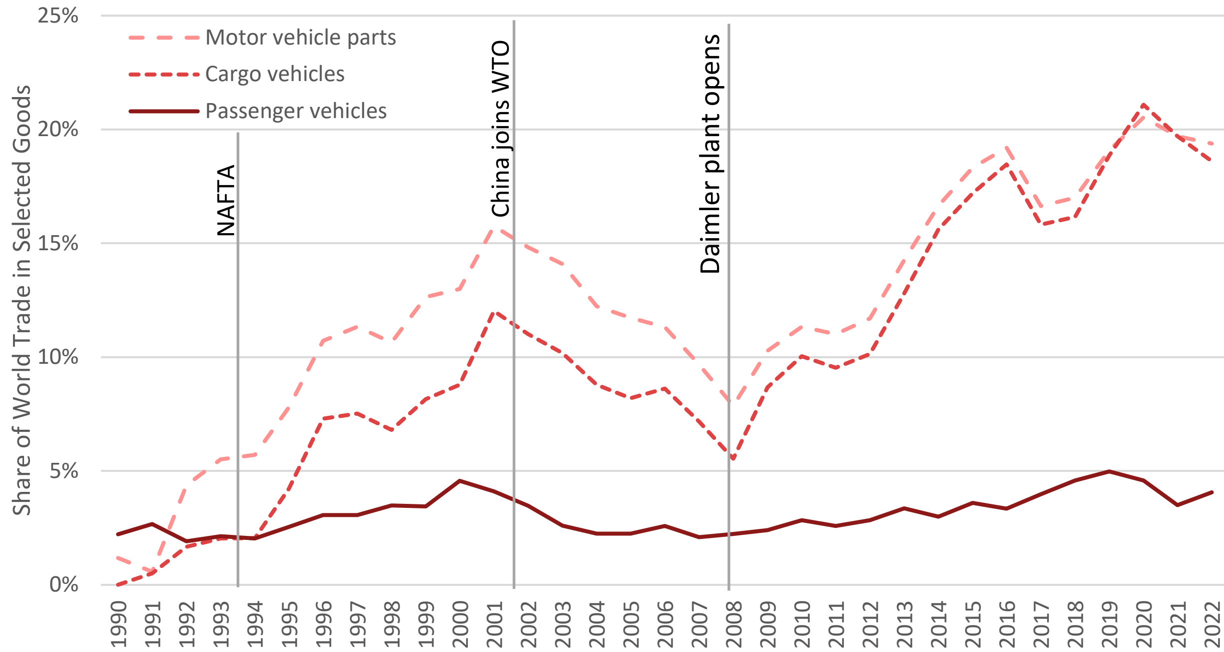


Source: Author compilation from UN Stats 2024 and USTR 2024.

A few of these merchandise categories have outsized importance in Mexico-US exports and thus merit additional discussion for their potential impacts in Mexico and the US. The most important of these sectors for Mexico-US exports are motor vehicles; motor vehicle parts; computers (also known as data processing machines); televisions and computer monitors; and telephones and modems. Together, these products accounted for approximately $152 billion in exports: 41 percent of all Mexico-US exports covered under the tariffs and 34 percent of all Mexico-US exports. The remainder of this section explores the trends in these Mexican manufacturing sectors over the last 30 years, including the potential impact of the Section 301 tariffs.

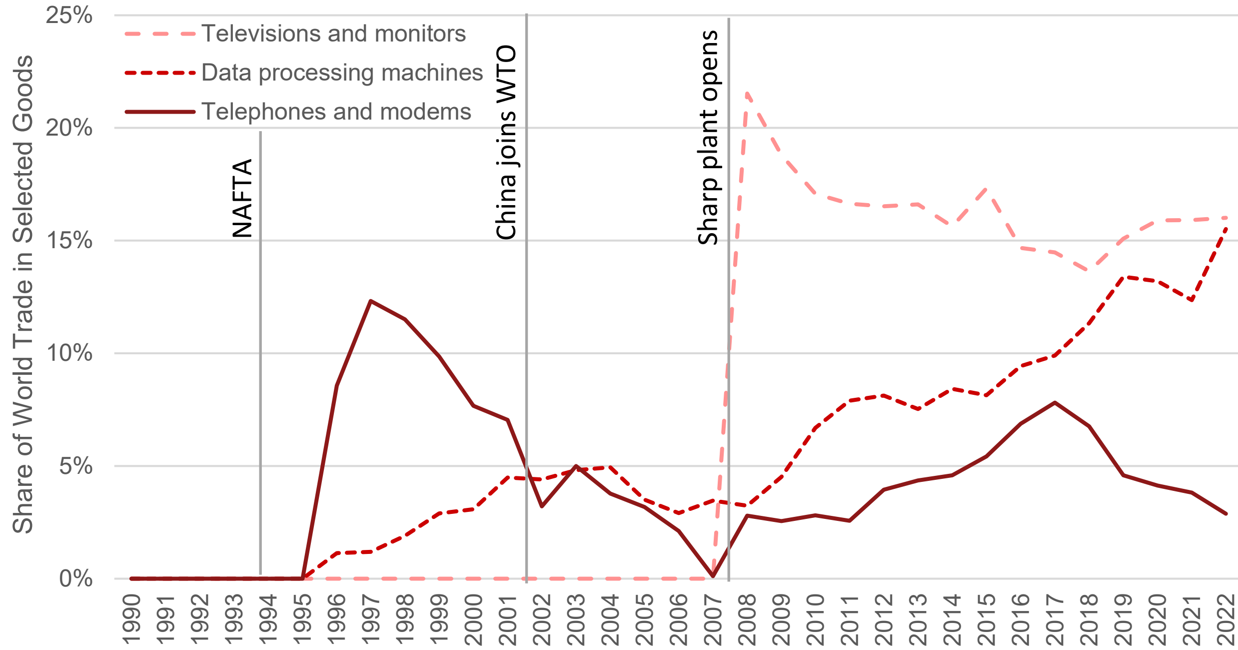
Figures 3 and 4 trace the growth of these exports as shares of world trade in each sector. Figure 3 shows the trends for motor vehicles and their parts, while Figure 4 does the same for selected electronics sectors.

Figure 3: Mexico-US Motor Vehicle Exports as a Share of World Trade



Note: HS tariff lines include targeted goods under the 8704 heading for cargo trucks, 8703 heading for passenger vehicles and 8708 and 8544.30 headings for motor vehicle parts.
Source: Author compilation from UN Stats 2024 and USTR 2024.

Figure 4: Mexico-US Electronics Exports as a Share of World Trade



Note: HS tariff lines include targeted goods under the 8471 heading for data processing machines, the 8528 heading for televisions and monitors and the 8517 heading for telephones and modems.
Source: Author compilation from UN Stats 2024 and USTR 2024.

Both figures show three significant moments in time: 1994, 2002 and 2008-2009. The first of these milestones, 1994, marks the entrance into force of the North American Free Trade Agreement (NAFTA). In 1993, Mexican exports to the US accounted for just 2.0 percent of world cargo vehicle trade and Mexico-US computer exports were non-existent. By 2001, Mexico-US exports accounted for 12 percent of world cargo truck trade and 7 percent of world trade in data processing machines. However, at the end of that year, China joined the World Trade Organization (WTO), and these trends began to reverse. A broad economic literature developed during the subsequent years charting the impact of easier trans-Pacific trade on the prospects for Mexican industrial development (see, for example, Dussel Peters and Gallagher 2013; Gallagher and Porzecanski 2010). These authors find that the availability of low-cost manufacturing in China broadly dampened the potential benefit of NAFTA for Mexican export-oriented manufacturing, as China stepped into its role as the "factory of the world."

The next major milestone came during the global recession of 2009. While global trade suffered significant shocks due to the financial crisis, the share of that trade occupied by Mexico-US exports remained relatively strong. In fact, although other forms of private capital flows declined in 2008 and turned negative in 2009, foreign direct investment (FDI) in developing countries grew in 2008 and remained nearly constant in 2009 (UNCTAD 2009). In the case of Mexico, significant new investments in the motor vehicle and computer sectors brought Mexico-US exports back up above 10 percent of world trade, where they have remained. Significant manufacturing expansion came through a new Daimler heavy truck facility in Saltillo and a new Sharp LCD television factory near Tijuana (Daimler 2009; Sharp 2008). Since that time, Mexico-US exports have grown rapidly in relative terms, peaking at over 20 percent of world trade in both televisions and cargo trucks.

In comparison with these major shifts, the 2018-2019 US tariffs do not seem to have led to significant increases in Mexico-US exports of these products, either as a share of Mexican exports (as shown in Figure 1), or as a share of global trade in those goods (as shown in Figures 2-4). Thus, it can be inferred that supply chains have not yet shifted to account for the Section 301 tariffs on goods from China.

However, new investments take significant time to come to fruition, especially given the impact of the COVID-19 pandemic on investment and trade globally. Chinese firms' announcements of new investments in these sectors in Mexico have growth substantially since 2018, as Table 1 shows, and this may be reflected in coming years.

Table 1: Chinese Participation in Mexican FDI, Selected Sectors

	Motor Vehicles and Parts		Electronics and Parts	
	2013-2017	2018-2022	2013-2017	2018-2022
Chinese FDI in Mexico	1.9	2.2	0.3	0.8
Other FDI in Mexico	36.1	19.2	2.6	3.7
China's Share of FDI in Mexico	5.1%	10.5%	11.6%	17.9%

Source: Author analysis of *Financial Times* 2024.

Chinese firms' announced intentions to invest in new or expanded projects in Mexico's motor vehicles sector rose slightly from $1.9 billion in the 2013-2017 period to $2.2 billion in the 2018-2022 period, while other firms' FDI announcements fell by nearly one-third, from $36.1 billion to $19.2 billion. Thus, China's share of the total more than doubled, from 5.1 percent to 10.5 percent. In Mexico's electronics sector, Chinese FDI announcements more than doubled from $344 million in the 2013-2017 period to $805 million in the 2018-2022 period, while other FDI announcements rose from $2.6 billion to $3.7 billion, and China's share rose from 11.6 percent to 17.9 percent. If these announcements yield actual investment in the coming years, it is likely that the increase in Chinese investment in these sectors will bring greater exports to the US and raise important policy questions for the US and Mexico alike.

3. Readiness for Potential Policy Challenges

The introduction of tariffs on goods from China has the effect of shifting the trade and policy context partially back to its state after NAFTA came into force but before China joined the WTO. To be clear, Mexico's global market share of certain products has already rebounded beyond the level of the immediate post-NAFTA years. Of the sectors shown in Figures 3 and 4, Mexico has regained its share of global trade for all categories but telephones and modems. Thus, it has greater potential now to absorb additional FDI in these sectors than it did 30 years ago, potentially bringing benefits for the Mexican economy.

Nonetheless, important policy considerations remain, and it is an opportune time to ensure that the USMCA framework is capable of addressing any risks that may arise. Throughout the

USMCA negotiations, scholars raised three major concerns that merit revisiting in this new context, particularly focused on enforcement of labor, environmental anti-corruption mechanisms. Optimizing governance in each of these three areas is crucial for mitigating the risk of undercutting free trade by evading the spirit of the agreement. Fortunately, in all three areas, USMCA includes strengthened provisions relative to NAFTA. However, opportunities remain to mitigate risks intrinsic in any investment or trade boom.

On *labor*, scholars such as Corvaglia (2021) and Polaski (2019) note the importance of strengthened labor provisions, including a specific commitment to address violence or threats of violence faced by workers. However, Polaski (2019) also points out the practical difficulties in enforcing these provisions without significant political will from Mexican leadership, which is subject to change with elections. Scholars are in broader agreement on the *environmental* improvements in USMCA, including the incorporation of environmental provisions into the main text and thus subjecting environmental matters to the Agreement's dispute settlement process, but also the lack of interface with multilateral environmental agreements, which is where most environmental policy coordination occurs, potentially raising the risk of friction with countries' commitments on climate and biodiversity conservation (Laurens et al 2019, Vaughan 2018). Finally, while the new *anti-corruption* provisions are well received, scholars note that these provisions are rarely enforceable in multilateral agreements (Chijioke-Oforji 2019; Puig 2019). Puig (2019) notes that, in this case, enforcement likely relies on unliteral action through the US Foreign Corrupt Practices Act rather than USMCA-specific resolution, raising the risk of *ad hoc* application of these improvements. Across all three areas, a consensus has arisen that while USMCA represents a significant step forward relative to NAFTA, enforcement continues to merit special attention.

A growing body of research shows that Chinese investors in Latin America tend to perform no worse on environment, labor and transparency standards than their Western peers. Nonetheless, these scholars note that regional governments continue to face challenges in maintaining and enforcing these standards. Ray et al (2015) find that Chinese state-owned enterprises in particular tend to meet, though not necessarily exceed, local social and environmental standards. These findings are encouraging in that host countries have the policy space to set and enforce the standards that best meet their development goals. However, Ray et al (2020, 2022) subsequently find a pervasive incentive among regional governments to reduce or evade those standards in order to attract or expedite foreign investment, even without external pressure. Finally, Albright, Ray and Liu (2023) find that Chinese firms have traditionally been less likely than their Western counterparts to bring investor-state dispute settlement (ISDS) cases regarding costs associated with complying with social and environmental regulations, but that may change as China-Latin America investment trends shift away from relying on state-owned enterprises toward greater participation of private Chinese enterprises. In this context, it is crucial for the US to lead by example through high-quality investment and to collaborate proactively with Mexican policymakers on institutional capacity for enforcement.

4. Policy Recommendations

The US has ample mechanisms for reinforcing institutional capacity within the USMCA and encouraging Chinese investors in Mexico to meet high-level performance. The US can pursue proactive and effective engagement by *leading by example* through the PGI, encouraging Chinese investors' *multilateral engagement* with bodies such as the Inter-American Development Bank (IDB) and *strengthening Mexican enforcement capabilities* through the Department of Labor (DOL) and the Environmental Protection Agency (EPA).

In the last few years, the US has taken important steps to *lead by example* through the creation of the Partnership for Global Infrastructure and Investment (PGI) and through its promotion among Group of 7 (G7) countries (White House 2023). The PGI enables greater coordination between the US and G7 lenders and investors to bring high-quality investment to priority sectors in low- and middle-income countries to raise living standards and build an inclusive and sustainable future. One important way that the US can support Mexico's ability to enforce its USMCA labor, environmental and transparency commitments is by continuing to build on the successes of the PGI. As Mexico continues to attract investment in the sectors targeted by tariffs, the presence of high-quality, economically successful investment will reduce the incentives to allow weakening or evasion of social and environmental standards. Continuing to strengthen and expand the PGI will help ensure that these standards are safe.

Secondly, the US can *encourage Chinese investors' multilateral integration* into Latin American investment mechanisms to help ensure that Chinese investment in Mexico meets the performance standards embedded in the USMCA. In 2012, the Export-Import Bank of China and the IDB established a joint equity platform that would support three investment windows: the China-LAC Infrastructure Fund, the LAC-China Mid Cap Corporate Fund and the LAC-China Natural Resources Fund. Investments made through this platform were held to IDB standards, which are among the most stringent in the world of development finance institutions. These funds were initially expected to last for 10 years with the possibility of two additional years of extension (IDB 2012). Twelve years later, while the US and China have worked to maintain open lines of communication, multilateral platforms are more necessary than ever as fora for accountability. Extending these joint China-IDB investment platforms can encourage Chinese investors to work through these well-established frameworks for high-quality investment.

Finally, the US can *strengthen Mexican enforcement capacity* through direct collaboration with the US DOL and EPA staff with their Mexican counterparts. For example, the Bureau of International Labor Affairs at DOL has an ongoing cooperation project with Verité, Inc. to build Mexican corporate, civil society and policymaker capacity to prevent child and forced labor. The EPA's participation with the Latin American Network for Environmental Enforcement and Compliance can build local capacity and also strengthen collaborative ties with their peers in Latin America in order to support each other's work. Continuing to build and expand on these types of cooperative efforts can ensure that civil society and enforcement officials have the resources and information to ensure that the USMCA social and environmental standards are met amid increasing Chinese investment in key sectors.

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OPENING STATEMENT OF ELIZABETH DRAKE, PARTNER, SCHAGRIN ASSOCIATES

COMMISSIONER GLAS: Thank you so much.

Ms. Drake?

MS. DRAKE: Good afternoon, Commissioners. I appreciate the opportunity to testify before you today.

In 2023, for the first time in over 20 years, China fell to our third largest source of imports behind Mexico and Canada, rather than our first largest source.

Since Section 301 duties were imposed on China in 2018, our imports from China have fallen by more than 20 percent while our exports to China have risen, shrinking our bilateral trade deficit by nearly one-third.

During the same period, however, our imports from other countries rose and our overall trade deficit continued to increase.

To be clear, I do not view these shifts as evidence that Section 301 tariffs are not working.

The tariffs provide needed leverage with an important trading partner.

In addition to the extent they have benefitted, producers in allied more market oriented Third Countries as well as producers in the United States, that is a positive outcome.

Based on our experience with shifts in trade after the imposition of antidumping and countervailing duties on goods from China, however, there is some cause for concern.

These shifts in trade after the imposition of duties on China may indicate that the duties are being circumvented or evaded.

It may also suggest that unfair Chinese trade practices are continuing to distort the U.S. market through investments in and exports from third countries.

It is vital that the United States use all of the tools at its disposal to ensure that any shifts in trade resulting from duties on China do not undermine the integrity of our tariff regimes or the resiliency of our supply chains.

We must ensure that the kinds of unfair practices in China that trade remedies are meant to address are not continuing to harm our businesses and workers because they are being transmitted to our market through circumvention, evasion, or goods that are produced in third countries with the benefit of Chinese subsidies or with the use of nonmarket inputs.

The first concern is circumvention and evasion. This is much easier to detect and address in the AD/CVD context than it is for Section 301 duties.

Since Congress passed the Enforce and Protect Act, or EAPA, in 2016, customs has launched more than 300 investigations, conducted over 45 overseas site visits, and identified over $1 billion of AD/CVD duties owed.

Since 2021, 44 out of the 45 affirmative evasion determinations that customs has made have involved orders on goods from China.

Evasion tactics have included transshipment, misclassification, and under valuation. Unfortunately, the EAPA process only applies to AD/CVD duties.

And thus, it is much more difficult to address similar tactics that may be affecting the collection of Section 301 duties.

In addition, the formal scope and circumvention proceedings that the Department of Commerce uses to enforce AD/CVD orders do not exist at all for Section 301 duties.

Moreover, goods subject to AD/CVD duties are not eligible for de minimis treatment, even if they enter under $800 per entry.

These goods must be imported through formal entry procedures. Goods subject to 301 duties, by contrast, are still eligible for de minimis treatment and informal entry procedures.

Second, even if exports from third countries result from real increases in investment and production in those countries and not through circumvention or evasion, there still may be reasons for concern.

The goal of Section 301 and AD/CVD duties is to remedy unfair trade practices by Chinese producers and the government of China.

To the extent that new exports from third countries now serve as a conduit for these same practices, they continue to distort trade and harm American producers and workers.

In 2023, as China fell to our third largest import source, China's greenfield outbound investment also hit record levels.

In the steel industry, for example, which was already plagued by global over capacity and widespread unfair trade practices, China now accounts for the majority of cross border investments in new steel capacity worldwide.

This growth in outbound investment reflects a number of factors, including not only the desire of Chinese companies to access markets free of duty liability, but also the government of China's "Going Out" policy and Belt and Road Initiative, as this Commission is well aware.

My testimony lays out examples of Chinese companies setting up shop in third countries to access the U.S. market within years or sometimes even months of AD/CVD petitions being filed on China.

These projects can involve not only the investment of capital by Chinese firms, including state-owned firms, but financial support from Chinese government-owned banks, and the provision of Chinese equipment and raw materials on nonmarket terms.

In such cases, petitioners must prepare and file entirely new petitions and reprove dumping subsidization and injury.

Unfortunately, even if they obtain relief, it does not fully address the continued unfair trade practices flowing from China.

These concerns go beyond specific AD/CVD cases reviewed in my written testimony. The Chinese Development Bank supporting BRI with public funds have not only been involved in infrastructure projects abroad, but also in the funding of plants producing chemicals, steel, forestry products, and textile materials, among many others.

The government of China has also supported the establishment of special economic zones in third countries that are explicitly designed to serve as export platforms.

Fortunately, there are a number of policy proposals that would address some of these issues. These including the bipartisan Leveling the Playing Field Act 2.0, proposals to reform the de minimis regime, and draft regulations issued by the Department of Commerce in May of last year to strengthen AD/CVD enforcement.

Enacting and implementing these proposals would go a long way toward counteracting evasion and circumvention of duties on goods from China, eliminating distortions due to transnational subsidies and third-country reliance on nonmarket inputs, and ultimately, ensuring that U.S. producers and workers can enjoy the full benefits of hard-earned relief from unfairly traded imports from China.

I look forward to your questions.

Thank you.

PREPARED STATEMENT OF ELIZABETH DRAKE, PARTNER, SCHAGRIN ASSOCIATES

Consumer Products from China: Safety, Regulation, and Supply Chains
Panel II: Shifting Production Networks and Challenges for Supply Chain Resiliency
Testimony before the U.S. – China Economic and Security Review Commission
Elizabeth J. Drake[1]
Partner, Schagrin Associates
March 1, 2024

I. Introduction

Since the imposition of Section 301 duties on goods from China in 2018 and 2019, U.S. imports from China have declined. As a result, China dropped from the first to the third largest source of U.S. imports in 2023 for the first time in years. U.S. antidumping ("AD") and countervailing duty ("CVD") orders have also proved effective in disciplining surges of unfairly traded imports from China. Some importers and Chinese producers have responded to these tariffs and trade remedies by shifting their sources of supply to third countries. While such shifts do not necessarily negate the effectiveness of these trade measures, they do raise concerns if they result from illegitimate circumvention or evasion schemes or constitute continued unfair dumping and subsidies injuring industries and workers in the United States.

This testimony proceeds in four parts. First, I review shifts in trade in response to Section 301 duties and AD and CVD duties on goods from China. The next section reviews the tools the U.S. government has to counteract circumvention or evasion schemes that may be causing trade to appear to shift while China in fact continues to enjoy duty-free access to the U.S. market. The third section reviews evidence that shifts in trade may be related to outbound investment and exports by Chinese firms, including with support from the Government of China. Finally, the last section concludes with policy recommendations to strengthen U.S. trade tools to address these concerns.

II. Shifts in Trade in Response to Tariffs and Trade Remedies on China

Since the imposition of Section 301 tariffs on imports from China in 2018 and 2019, U.S. imports from China have fallen, the U.S trade deficit with China has declined, China's share of total U.S. imports has shrunk, and, as of 2023, China is no longer ranked as the top source of U.S. imports. From 2018 to 2023, the value of annual U.S. imports from China shrank by $121.9 billion, or 22.4 percent.[2] While U.S. exports to China initially declined in 2019, they were higher than 2018 levels in each year from 2020 to 2023. As a result, the annual U.S. trade deficit with China fell by $137.8 billion dollars, or 31.8 percent, from 2018 to 2023.

These shifts in trade with China occurred even though overall U.S. imports (and the overall U.S. trade deficit) grew from 2018 to 2023. Total imports from the world rose by $528.8 billion, or 20.8 percent. At the same time, the U.S. global trade deficit increased by $251.3 billion, or 22.1

[1] This testimony reflects the individual views of the author, and not necessarily the views of Schagrin Associates or any of its clients.

[2] USITC Trade DataWeb, imports for consumption, customs value. All U.S. import and export figures are from DataWeb and reflect trade in goods only.

percent. But China's direct role in U.S. imports and the U.S. trade deficit fell sharply. From 2018 to 2023, China's share of U.S. imports fell from 21.3 percent to 13.7 percent. Similarly, China's share of our trade deficit fell from 38.2 percent to 21.3 percent.

In 2023, China fell from its position as the top source of U.S. imports for the first time since it reached that position in 2007. Last year, China was our third largest import source rather than our largest. In 2023, the U.S. imported more from Mexico and more from Canada than it imported from China, a situation that last occurred more than two decades ago, in 2002.

As imports from China fell in response to the imposition of Section 301 tariffs, imports from certain other countries appeared to benefit. From 2018 to 2023, imports from Korea, Vietnam, Taiwan, and India rose by 54.8 percent, 120.1 percent, 91.3 percent, and 53.7 percent, respectively. Vietnam's growth has been especially rapid, allowing it to rise from our twelfth-largest source of imports in 2018 to our seventh-largest in 2023. At the same time, China's own exports to these countries have also grown.

U.S. Imports from, and Chinese Exports to, Top U.S. Import Sources[3]

Country	**2023 U.S. Imports (US$ Billion)**	**Change in U.S. Imports, 2018 - 2023**	**Change in China Exports, 2018 - 2022**
Mexico	$473.4	37.5%	76.2%
Canada	$421.5	32.2%	52.8%
Germany	$162.2	28.3%	50.0%
Japan	$151.3	5.4%	17.6%
Korea	$155.7	54.8%	49.5%
Vietnam	$112.4	120.1%	75.2%
Taiwan	$87.3	91.3%	n/a
India	$84.3	53.7%	54.5%

To be clear, the data do not suggest that the Section 301 duties have not been successful. To the contrary, the duties have been remarkably effective at reducing U.S. imports from China, and they have reduced the U.S. trade deficit with China even more sharply. To the extent that allied countries with more market-based practices have also benefitted, that can be seen as a positive result.

What the data do suggest, however, is that U.S. importers who have shifted their sources away from China in reaction to the Section 301 duties may nonetheless be providing a conduit for upstream goods that are still produced in China and incorporated into global supply chains in third countries before being imported into the United States. A more detailed analysis at a product-by-product level would be needed to demonstrate the extent to which these shifts in trade in fact represent a shifting of supply chains that still provides an outlet for Chinese production. Moreover, as reviewed in more detail below, current enforcement mechanisms for

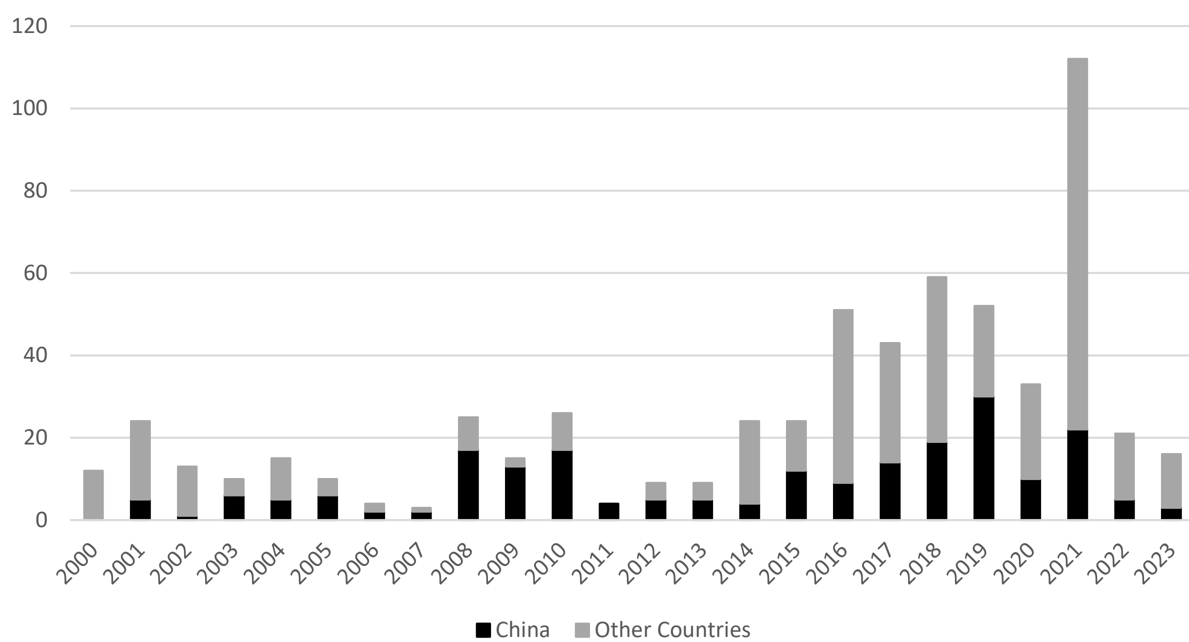
[3] *Id*. China's exports are from UN Comtrade. The latest year for which data is available is 2022. These comparisons should be treated with caution given the longstanding discrepancies between U.S. import data and China's export statistics.

Section 301 should be strengthened to ensure the duties are not being unfairly circumvented through transshipment or other schemes involving third countries.

Similar shifts in trade that have been seen in response to Section 301 duties have also occurred in the context of other trade remedies. The imposition of Section 301 duties on imports from China in 2018 and 2019 came amidst the imposition and continuation of numerous antidumping ("AD") and countervailing duty ("CVD") orders on goods from China. From 2000 to 2023, the U.S. imposed 614 AD and CVD orders on unfairly traded goods from various countries.[4] Of these, 216 of the orders – or 35.2 percent – have been on goods from China.[5] This was during a period when imports from China accounted for an average of 17.3 percent of total U.S. goods imports.

The data show that the overall number of AD and CVD orders the U.S. has imposed has risen unevenly since 2000, reaching a peak of 112 orders imposed in 2021. In fourteen of the twenty years from 2000 to 2019, new orders on imports from China accounted for half or more of the new orders imposed each year. The share of new AD/CVD orders accounted for by orders on China has fallen since that time, with orders on China accounting for 30 percent or less of new orders in 2020 through 2023.

U.S. Imposition of Antidumping and Countervailing Duty Orders by Year[6]



One explanation for these trends, particularly in recent years, is the phenomenon of successive investigations on the same product from different countries. As U.S. industries and workers have

4 Author's calculations.

5 *Id.*

6 *Id.*

successively obtained AD/CVD orders on dumped and subsidized product from China, they have all too often seen a surge in imports of the same product from other countries shortly after the orders on China are imposed, or even while the investigation on China is still pending. As reviewed below, these shifts in trade patterns are sometimes fueled by outbound investments in third countries by the very same Chinese producers that were subject to the original orders.

Thus, to preserve the market discipline the original orders were intended to provide, domestic producers and workers are often forced to seek successive investigations on the same product. Not only must petitioners show that the products from the third countries are also being dumped below normal value and/or subsidized, but they must also once again show that they are being materially injured by the new group of imports in question. This requires a showing of injury during a time period when the industry should have been reaping the benefits of AD and CVD duties on the original Chinese imports of concern. A non-exhaustive list of products that have been the subject of such successive investigations is below.

Examples of Successive AD and CVD Investigations[7]

Product	**First Investigation**		**Successive Investigations**	
	Country	**Orders**	**Country(ies)**	**Orders**
Aluminum Extrusions	China	2011	China, Colombia, Dominican Republic, Ecuador, India, Indonesia, Italy, Malaysia, Mexico, South Korea, Taiwan, Thailand, Turkey, United Arab Emirates, Vietnam	Pending
Aluminum Foil	China	2018	Armenia, Brazil, Oman, Russia, Turkey	2021
Boltless Steel Shelving	China	2015	India, Malaysia, Taiwan, Thailand, Vietnam	Pending
Citric Acid	China	2009	Belgium, Colombia, Thailand	2018
Common Alloy Aluminum Sheet	China	2019	Bahrain, Brazil, Croatia, Egypt, Germany, India, Indonesia, Italy, Oman, Romania, Serbia, Slovenia, South Africa, Spain, Taiwan, Turkey	2021
Laminated Woven Sacks	China	2008	Vietnam	2019
Mattresses	China	2019	Bosnia and Herzegovina, Bulgaria, Burma, China, Cambodia, India, Indonesia, Italy, Kosovo,	2021 and Pending

7 Author's analysis of AD and CVD orders and petitions.

Product	First Investigation		Successive Investigations	
	Country	Orders	Country(ies)	Orders
			Malaysia, Mexico, Philippines, Poland, Serbia, Slovenia, Spain, Taiwan, Thailand, Turkey, Vietnam	
Melamine	China	2015	Germany, India, Japan, Netherlands, Qatar, Trinidad and Tobago	Pending
Non-Refillable Steel Cylinders	China	2021	India	Pending
Passenger Vehicle and Light Truck Tires	China	2015	Korea, Taiwan, Thailand, Vietnam	2021
Quartz Surface Products	China	2019	India, Turkey	2020
Steel Nails	China	2008	Vietnam, Korea, Malaysia, Oman, Taiwan, United Arab Emirates	2012 and 2015
Steel Wire Garment Hangers	China	2008	Taiwan, Vietnam	2012, 2013
Truck and Bus Tires	China	2019	Thailand	Pending
Utility Scale Wind Towers	China and Vietnam	2013	India, Malaysia, Spain, Malaysia, Canada, Indonesia, Korea, Vietnam	2020 and 2021

Again, to be clear, the fact that importers shift sources of supply in response to Section 301 tariffs and AD and CVD duties does not mean these tariffs are not effective or not serving their intended purpose. Section 301 duties serve as important leverage and signal to China that disregard for intellectual property rights, technology transfer requirements, and other predatory practices are unacceptable. AD and CVD duties remedy injurious dumping and subsidies, restoring needed price and volume discipline to the market for vulnerable domestic industries and their workers.

There are, however, at least two broad sets of concerns the above patterns raise.

First, are the shifts in patterns of trade legitimate? In other words, are the new suppliers in third countries actually producing the good in question, or are they simply serving as conduits for transshipment or only minor processing that does not fundamentally transform the product in question? In such cases, strict enforcement of existing anti-circumvention and transshipment disciplines is needed, as well as the consideration of new tools to counteract such practices.

Second, to the extent the new supplier in the third country really is producing or substantially transforming the product in question, is the production of those goods in the third country nonetheless still distorted by unfair Chinese trade practices? This can include the third-country producer's reliance on Chinese equipment and inputs imported at non-market prices. In addition, as Chinese companies, including state-owned enterprises ("SOEs"), invest in production in third countries with support from the Government of China, those Chinese government subsidies may continue to distort production decisions, fuel overcapacity, and depress prices. New tools are needed to remedy these practices as well.

The next two sections address these concerns in turn.

III. Evasion and Circumvention of Tariffs and Trade Remedies

Chinese producers and importers have resorted to a number of strategies to evade duty liability in order to continue to access the attractive U.S. market after duties are imposed. These practices have been most well-documented in the AD/CVD context, where the U.S. Department of Commerce ("Commerce") and U.S. Customs and Border Protection ("CBP") have the tools to address such schemes, and domestic industries that have petitioned for relief tend to be vigilant in monitoring enforcement of the duty orders they have obtained.

In 2016, the Enforce and Protect Act ("EAPA") was signed into law, greatly increasing the transparency of CBP's enforcement efforts regarding AD and CVD duties.[8] Under EAPA, outside interested parties may file allegations that an importer is evading AD or CVD duties. EAPA gave CBP new tools to investigate such allegations, and created a more transparent, multi-party process with fixed timelines for CBP to determine whether evasion has occurred and take corrective action.

EAPA has been used frequently since its enactment, and with a fair amount of success. According to CBP, the agency has launched more than 300 EAPA investigations, conducted over 45 on-site visits or verifications overseas as part of its investigations, and identified over one billion dollars of AD/CVD duties owed to the U.S. government.[9]

While a detailed review of every EAPA investigation is beyond the scope of this testimony, a snapshot of cases with determinations over the past three years provides some insight. CBP summarizes 45 unique investigations in which affirmative preliminary or final evasion determinations have been issued since January of 2021.[10] Of these 45 cases, 44 involved evasion of an AD and/or CVD order on a product from China. The types of evasion schemes included transshipment through a third country, misclassification of merchandise as not subject to the order, the use of Chinese subject parts that were not declared and/or only minimally processed in the exporting country, and the undervaluation of imports.[11] In some cases, the evasion scheme

[8] U.S. Customs and Border Protection, "Enforce and Protect Act (EAPA)", available on-line at https://www.cbp.gov/trade/trade-enforcement/tftea/eapa#:~:text=EAPA%20establishes%20procedures%20for%20an,(AD%2FCVD)%20duties.

[9] *See id*.

[10] *See* U.S. Customs and Border Protection, "Recent EAPA Actions", available on-line at https://www.cbp.gov/trade/trade-enforcement/tftea/eapa/recent-eapa-actions.

[11] Because most AD/CVD duties are assessed on an *ad valorem* basis, undervaluation artificially reduces duty liability.

involved multiple practices, such as mis-identifying a product as being both from a non-subject country and falling within a specific product exclusion.

The countries and products involved in these 44 cases were diverse. Evasion of AD/CVD Orders on China was found with regard to products that were imported (or declared as imported) from Cambodia, the Dominican Republic, India, Indonesia, Malaysia, Mexico, Sri Lanka, Thailand, Turkey, and Vietnam. Among the countries cited, Malaysia and Vietnam are cited most frequently. The evasion schemes affected a broad array of products, including many consumer products. The products involved include aluminum extrusions, cast iron soil pipe, cast iron soil pipe fittings, chassis and subassemblies, common alloy aluminum sheet, diamond sawblades, forged steel fittings, glycine, quartz surface products, steel grating, steel wheels, steel wire garment hangers, thermal paper, wooden bedroom furniture, wooden cabinets and vanities, and xanthan gum.

Another important tool that has been used to enforce AD/CVD remedies is the anti-circumvention statute administered by Commerce,[12] as well as Commerce's authority to administer the scope of its AD and CVD Orders. The circumvention provisions allow Commerce to investigate allegations of circumvention (or self-initiate investigations) to determine if goods not technically subject to an existing AD or CVD order are in fact circumventing the order. Examples of such practices covered by the statute include completion or assembly of inputs into covered merchandise in the U.S. or a third country where the completion or assembly process is only minor or insignificant; minor alterations to the merchandise to take it technically outside of the scope; and the later development of merchandise that is generally the same as the merchandise covered by the order in question.[13] Commerce can also use its existing scope authority to determine whether an imported good was actually transformed in a third country or retains the country of origin of a country covered by an order.

Over the past few years, Commerce has taken a number of steps to strengthen its enforcement of the circumvention statute. First, Commerce has begun to self-initiate its own circumvention investigations and scope inquiries from time to time,[14] which reduces some of the burden on petitioners and sends a strong signal to importers and foreign producers that patterns of trade are being monitored for possible circumvention and evasion schemes. Second, Commerce has strongly defended its authority to determine for itself what the country of origin of an imported

[12] *See* 19 U.S.C. § 1677m.

[13] *See id*.

[14] *See e.g.*, U.S. Department of Commerce, "Department of Commerce Self-Initiates Scope and Circumvention Inquiries Into Possible Circumvention of AD/CVD Orders on Quartz Surface Products From China" (Feb. 2, 2022), available online at https://www.trade.gov/press-release/department-commerce-self-initiates-scope-and-circumvention-inquiries-possible. *See also* U.S. department of Commerce, "U.S. Department of Commerce Self-Initiates Circumvention Inquiry Involving Exports of Stainless Steel Sheet and Strip Completed in Vietnam" (May 12, 2020), available online at https://www.trade.gov/press-release/us-department-commerce-self-initiates-circumvention-inquiry-involving-exports.

good is in order to enforce the scope of its orders, and this authority has been upheld by the U.S. Court of Appeals for the Federal Circuit.[15]

Third, in 2021, Commerce promulgated strong new scope and circumvention regulations codifying its practice and providing clarity to practitioners.[16] In the scope context, Commerce clarified that a finding that a good is within the scope means that good was always within scope, and thus that duties should have been paid on the imports since the original order was imposed. In the circumvention context, Commerce implemented an important change to its regulations allowing affirmative circumvention determinations to also be imposed retroactively in certain circumstances, though that authority is still not regularly used.

Despite these advances, there are still gaps in the enforcement tools available to counteract circumvention and evasion. First, EAPA only applies to AD/CVD duties, and not to other duties such as safeguard duties, Section 301 duties, and Section 232 duties. Thus, the private sector has no formal role in helping Customs guard against evasion of these vitally important duties, and the enforcement process is opaque. Second, EAPA cases and findings are still specific to particular named importers, forcing petitioners to determine the relevant importer name based on publicly available information and sometimes file multiple successive allegations regarding the same products and the same evasion schemes. Third, the presumption against retroactive application of circumvention findings can deprive petitioners of meaningful relief if the circumvention practice ends once an allegation is initiated but prior violations are never remedied.

Finally, the *de minimis* loophole for individual entries valued under $800 makes it much more difficult to track whether importers may be engaging in similar schemes to avoid Section 301 duties. While goods subject to AD/CVD duties are not eligible for *de minimis* treatment, the same rule does not apply to goods subject to Section 301 duties.[17] Thus, even goods that should be paying Section 301 duties can be entered informally as *de minimis* shipments, and thus avoid such duty liability. It is also harder for CBP to perform risk targeting to aid enforcement efforts regarding such imports without formal entries that permit CBP to track patterns of trade and shifts in importers and foreign shippers that may indicate circumvention or evasion.

IV. The Role of Chinese Outbound Investment and Transnational Subsidies

As reviewed above, shifts in production to third countries in response to tariffs and trade remedies on goods from China may occur not as the result of circumvention or evasion in the traditional sense but as the result of the creation of new or enhanced production platforms in third countries. In some cases, these investments are carried out by the same Chinese producers that produced the goods in China that were originally found to be dumped or subsidized in the

15 *See Bell Supply Company, LLC v. United States*, 888 F. 3d 1222 (Fed. Cir. 2018).

16 *See Regulations To Improve Administration and Enforcement of Antidumping and Countervailing Duty Laws*, 86 Fed. Reg. 52,300 (Dep't Commerce Sept. 20, 2021).

17 *See* U.S. Customs and Border Protection, "Section 301 Trade Remedies Frequently Asked Questions," available online at https://www.cbp.gov/trade/programs-administration/entry-summary/section-301-trade-remedies/faqs .

U.S. market or subject to other remedies such as Section 301 duties. This includes SOEs and other firms backed by the Government of China. As part of its "Going Out" strategy and the Belt and Road Initiative, the Government of China also provides generous financial support for outbound investment through its development banks and other state-owned financial institutions. Producers in third countries may also benefit from access to imported capital equipment and inputs from China that are themselves sold at non-market prices, as well as Chinese labor that is easily exploited to gain an unfair advantage. Unfortunately, none of these practices are currently being counteracted by the U.S. government through its AD/CVD laws or enforcement of Section 301 duties.

In response to AD and CVD orders, Chinese firms have shown the willingness and ability to establish production platforms in third countries in order to continue accessing the U.S. market free from duty liability. In 2015, for example, the U.S. imposed AD and CVD duties on imports of passenger vehicle and light truck tires from China. Imports from China were slashed by more than half from 2014 to 2015 – from over 58 million tires to 26 million – and imports from China have continued to fall, hitting just 3.3 million tires in 2023. The orders resulted in significant new investments in the United States: Kumho built a new plant in Macon, Georgia in 2015, Hankook constructed a new facility in Clarksville, Tennessee in 2016, Giti built a new plant in Richburg, South Carolina in 2017, and Nokian started producing at its new plant in Dayton, Tennessee in 2019.[18] The orders thus brought added capacity, production, and jobs to the United States as imports from China were disciplined.

Unfortunately, Chinese producers were also eager to keep accessing the attractive U.S. market despite the orders through new investments outside of the United States. Two Chinese producers, Sentury and Zhongce, opened plants in Thailand in 2015 just as orders were being imposed on China.[19] Additional new plants opened in Thailand in 2017 and 2019, in Vietnam in 2014 and 2017, and in Taiwan in 2017.[20] The result was a renewed surge in imports of unfairly traded PVLT tires, this time from Korea, Taiwan, Thailand, and Vietnam, forcing domestic tire workers to file a new round of petitions in 2020.

A similar dynamic occurred regarding truck and bus tires from China. After AD and CVD petitions were filed in 2016 and orders were imposed on China in 2019, imports from China fell from 9.2 million tires in 2018 to barely over a million tires in 2023. Since the petitions were filed, three Chinese producers opened plants in Thailand, including Double Coin Holdings in 2017, Jiangsu General Science Technology Co. Ltd. in 2019, and Prinx Chengshan in 2020.[21] Together, these three plants alone have the capacity to produce over eleven million tires a year, more than the U.S. imported from China at its peak. As a result of these and other investments, Thai exports of truck and bus tires to the United States more than doubled from 4.8 million tires in 2020 to 10.1 million tires in 2022, and domestic tire workers were forced to once again petition the U.S. government for relief.

18 *See Modern Tire Dealer*.

19 *See id*.

20 *See id*.

21 *See id*.

In some cases, Chinese producers contribute not only capital but also equipment and inputs to ramp up production in third countries in response to AD and CVD orders on products from China. In 2019, for example, while AD and CVD petitions on quartz surface products from China were still pending, Chinese companies began exporting machinery and raw materials to India for conversion into quartz countertops. In an earnings call in February 2019, Pokarna, a major Indian producer, described the situation as follows to its investors:

> {W}e are also seeing mushrooming of quartz manufacturers in India, predominantly using Chinese machineries and process to capitalize on their growth opportunities being thrown open by the tariff and duty situations coming out from the US. . . . We do not track the names but I can say that they will be in double digit numbers.[22]

Another company official offered the following additional information during the Pokarna earnings call:

> {S}peaking to a lot of this upcoming quartz companies, what I get to know is a lot of Chinese companies are giving them plant and machinery at a zero cost for the first line and they are just charging them for the second line, that means lot of tie-ups have happened in such a way and even speaking to many stockist, super stockists in Los Angeles, they are also of the view that we are open to source from many other players in India, so when this trade will shift from China to India and lot of these Chinese companies are saying that you manufacture 100 percent for us and then you sell via India, we will give you the technology and everything.[23]

These are not isolated examples. As reviewed in Section II, above, China's exports have also increased to top U.S. trading partners since the imposition of Section 301 duties. In addition, Chinese outbound greenfield investments are rising, supported by the Government of China's "Going Out" policy and Belt and Road Initiative. China's outbound greenfield foreign direct investment hit record levels in 2023.[24] According to one analyst, the decision to invest is driven by overcapacity, slowing growth in China, the Chinese government's policies, and the desire to access new markets.[25]

The steel industry is a prime example. According to the Organization for Economic Cooperation and Development, the ongoing global steel excess capacity crisis is only accelerating, due to investments by China not only at home but also increasingly abroad:

[22] Transcript of Pokarna Earnings Call (Feb. 19, 2019) at 3.

[23] *Id.*

[24] *See* fDi Intelligence, "Chinese outbound FDI boom signals 'newphase'" (Oct. 3, 2023), available online at https://www.fdiintelligence.com/content/data-trends/chinese-outbound-fdi-boom-signals-new-phase-83013.

[25] *Id*.

> Capacity expansions by Chinese companies in third countries, through cross-border investments, account for 65.1% of total cross-border investments in new steelmaking capacity taking place around the world. Their investments in ASEAN account for 81% of the region's total capacity expansion. Furthermore, the information analysed in this report suggest that outdated induction furnaces, which do not meet environmental and product quality standards, are frequently imported into ASEAN economies, raising concerns in local communities.[26]

Thus, in one of the world's most trade-sensitive industrial sectors which is already plagued by uneconomic overcapacity, Chinese investments are a leading cause of increasing capacity in third countries. Steel produced in these facilities will not be treated as Chinese in origin, and thus when this steel is exported it will not be subject to existing AD and CVD measures or any other trade remedies that apply on steel from China.

Consistent with Chinese government policies, these overseas investments may be benefitting from generous support from Chinese state-owned financial institutions such as the China Export-Import Bank, the China Development Bank, and others. According to Boston University's Global Development Policy Center, overseas investments supported by these Chinese public institutions include investments in plants producing automobiles, cardboard, cement, chemicals, locomotives, metals, plastics, steel, textiles, and timber products in Asia, Eastern Europe, and South America.[27] The Government of China is also involved in setting up Special Economic Zones in third countries that take advantage of Chinese investment and technology to create export platforms for a variety of products.[28]

Another troubling trend is the exploitation of Chinese and home country workers in projects supported by the Government of China abroad. According to the U.S. Department of State:

> PRC and host country nationals employed in some BRI construction projects, mining operations, and factories in African, European, Middle Eastern, Asian, Pacific, Latin American, and Caribbean countries experience deceptive recruitment into debt bondage, arbitrary wage garnishing or withholding, contract irregularities, confiscation of travel and identity documentation, forced overtime, and resignation penalties, as well as intimidation and threats, physical violence, denial of access to urgent medical care, poor working and living conditions, restricted freedom of movement and communication, and retaliation for reported abuses. Those who escape often find themselves at the mercy of local

[26] Organization for Economic Cooperation and Development, *Latest Developments in Steelmaking Capacity 2024* (2024) at 4.

[27] Boston University Global Development Policy Center, China's Overseas Development Finance Database, available online at https://www.bu.edu/gdp/chinas-overseas-development-finance/.

[28] *See* Angela Tritto and A. Camba "State-facilitated Industrial Parks in the Belt and Road Initiative: Towards a framework for understanding the localization of the Chinese development model," *World Development Perspectives*, Vol. 28 (Dec. 2022).

immigration authorities, who are not always trained to receive or care for trafficking victims.[29]

Labor advocacy groups have documented similar labor concerns in overseas projects supported by China's Belt and Road Initiative.[30] The ability to exploit workers with impunity is not only immoral, it also creates another unfair competitive advantage for producers in third countries backed by Chinese government support.

Unfortunately, the U.S. currently is not effectively employing any tools to counteract these types of unfair trade practices associated with Chinese support for overseas manufacturing. Commerce's "non-market economy" AD methodology only applies in cases on imports from non-market economy countries. The fact that a market economy producer in India, for example, may be using equipment and raw materials imported from China at non-market prices is thus not directly remedied under current AD law. In addition, subsidies from the Government of China to producers in other countries – including financing from state-owned banks, equity infusions from SOEs, infrastructure and services in Special Economic Zones, and access to workers with few to no basic labor rights – are not currently countervailed by Commerce in CVD investigations on products from third countries. Instead, Commerce currently requires that the subsidy must be provided by the government in the country of manufacture,[31] an outdated requirement that fails to reflect current practice by the Chinese Government and Chinese firms. This failure to act also falls short of what the European Union has already been doing under its own CVD regime to counteract Chinese government subsidies benefitting producers in third countries.[32]

In short, Chinese firms have responded to tariffs and trade remedies by investing in overseas production, and these investments are consistent with the "Going Out" policies of the Government of China and the Belt and Road Initiative. The U.S. needs to adapt to these trends by strengthening and modernizing its trade remedy regime. Specific policy recommendations are set out in more detail below.

V. Policy Recommendations

There are a number of steps that Congress and the Administration can take to strengthen U.S. trade remedy and enforcement tools to address the concerns about evasion, circumvention, transnational subsidies, and embedded non-market economy inputs described above. Many of these proposals have already been incorporated into pending legislation such as the Leveling the Playing Field 2.0 Act ("LTPFA 2.0") and regulatory changes proposed by Commerce in May of

29 U.S. Department of State, Office to Monitor and Combat Trafficking in Persons, "Forced Labor: The Hidden Cost of China's Belt and Road Initiative."

30 *See, e.g.*, *Trapped: The Belt and Road Initiative's Chinese Workers*, China Labor Watch (Nov. 2022).

31 *See* 19 C.F.R. § 351.527.

32 *See* Renato Antonin, et al. "EU Court recognizes transnational subsidies are countervailable" Global Trade and Investment Law Blog (Mar. 21, 2023), available online at https://www.steptoeglobaltradeblog.com/2023/03/eu-court-recognizes-transnational-subsidies-are-countervailable/ .

last year that would strengthen the enforcement of trade remedy laws ("2023 Proposed Enforcement Rules").[33]

1. Apply EAPA standards and procedures to evasion of Section 301 and 232 duties. As noted above, the EAPA process currently only applies to the evasion of AD/CVD duties. LTPFA 2.0 proposes extending EAPA to evasion of Section 201 safeguard duties.[34] EAPA should also be expanded to cover evasion of other important duty programs such as Section 301 and Section 232.

2. Streamline EAPA investigations of multiple importers. As noted above, currently EAPA investigations are limited to individual importers named by the petitioner, limiting the reach of affirmative evasion findings. As proposed in the Customs Modernization Act of 2023, CBP should be able to share the name of importers of concern with petitioners when they submit an EAPA allegation, and CBP should be allowed to include any other importers it believes may be involved when it finds there is reasonable suspicion sufficient to launch an EAPA investigation.[35]

3. Make affirmative circumvention findings presumptively retroactive. As noted above, under Commerce's new regulations implemented in 2021, the agency has the discretion to make affirmative circumvention findings retroactive to entries prior to the date of initiation of the inquiry, but Commerce rarely does so in practice.[36] Commerce should amend its regulations to make such retroactive application presumptive, or, at a minimum, to provide guidance to parties on the factors Commerce will consider in making its findings retroactive.

4. Exclude all merchandise subject to higher duty levels from eligibility for de minimis treatment. There are numerous proposals for fixing the current de minimis loophole that allows many entries to escape duty liability. As noted above, informal entry also makes it more difficult for CBP to track potential evasion and circumvention of 301 duties. CBP already has the ability to deny de minimis eligibility to protect the revenue,[37] and it should invoke this authority to exclude any entries subject to Section 301, Section 232, Section 201, or other elevated duties from de minimis eligibility.

5. Streamline successive trade remedy investigations. As noted above, in far too many cases domestic industries and workers have been forced to petition repeatedly for relief

[33] *See* Leveling the Playing Field 2.0 Act, H.R. 3882 ("LTPFA 2.0"). S*ee also Regulations Improving and Strengthening the Enforcement of Trade Remedies Through the Administration of the Antidumping and Countervailing Duty Laws*, 88 Fed. Reg. 29,850 (Dep't Commerce May 9, 2023) ("2023 Proposed Enforcement Rules").

[34] LTPFA 2.0 at Sec. 502.

[35] Customs Modernization Act of 2023, S. 3431 at Sec. 304.

[36] *See* 19 C.F.R. § 351.226(*l*)(2)(iii)(A) and (3)(iii)(A).

[37] *See* 19 U.S.C. § 1321(b) (Customs may prescribe exceptions to the de minimis provisions if it is "necessary for any reason to protect the revenue or to prevent unlawful importations"). *See also* 19 C.F.R. §§ 143.22 and 145.12(a) (permitting CBP to require formal entry to protect the revenue).

from successive waves of unfairly traded imports. This often occurs when a first set of cases is successful in disciplining dumped and subsidized imports from China, but production then shifts to third countries, resulting in a renewed surge of unfairly traded imports. Enactment of LTPFA 2.0 would address this problem by establishing special rules for such successive investigations to reduce burdens on petitioners and the agencies and expedite relief.[38]

6. Empower Commerce to countervail transnational subsidies. As explained above, Commerce's regulations currently prohibit the agency from countervailing subsidies provided by a government in one country to a recipient in a third country.[39] This regulation is not required by statute and should be deleted from Commerce's regulations, as Commerce proposed in May of 2023.[40] In addition, LTPFA 2.0 includes provisions that would amend the statute to address cross-border subsidies.[41] These provisions should be reviewed and enacted to ensure they address the full range of cross-border subsidy practices that may be distorting international trade.

7. Prohibit Commerce from relying on costs that are distorted by non-market economy inputs, unfair trade practices, and government intervention. As noted above, when importers shift sourcing from China to other countries, imports from the third country may still be produced using equipment and inputs from China, yet these non-market inputs are not taken into account in Commerce's AD calculations. There are several steps that could address these concerns. First, LTFPA 2.0 would allow Commerce to disregard inputs from non-market economy suppliers, as well as from SOEs and suppliers that are subsidized or have found to be engaged in dumping, and value those inputs at undistorted rates.[42] Another step would be to strengthen Commerce's ability to address costs that are distorted by a particular market situation ("PMS"). LTFPA 2.0 would clarify that Commerce has the ability to address a cost-based PMS regardless of its basis for normal value, correcting court decisions to the contrary that have frustrated Congressional intent in this regard.[43] LTFPA 2.0 and Commerce have also proposed revisions that would identify the types of scenarios that give rise to a PMS.[44] While codification of such scenarios will be helpful, it is important that such codification expand rather than restrict Commerce's authority to counteract such distortions.

8. Ensure Commerce can address violations of labor rights and human rights in its AD and CVD calculations. As reviewed above, government failures to guarantee basic labor rights have also raised concerns about practices in Chinese-backed investment projects.

38 LTPFA 2.0 at Secs. 101 – 103.

39 *See* 19 C.F.R. § 351.527.

40 *See* 2023 Proposed Enforcement Rules.

41 LTPFA 2.0 at Sec. 201.

42 *See id*. at Sec. 205.

43 *See id*. at Sec. 204.

44 *See id. See also* 2023 Proposed Enforcement Rules at Sec. 416.

> Commerce has proposed addressing such distortions by considering the failure to enforce labor rights and human rights when selecting surrogate values and benchmarks, treating the failure to pay required fees, fines, and penalties as countervailable subsidies, and considering the failure to enforce labor and human rights as a PMS that can distort the cost of production.[45] LTFPA 2.0 would also codify that the failure to implement and enforce labor and human rights standards can give rise to a PMS.[46]

Together, these policy actions would go a long way to strengthening our trade remedy tools and enforcement measures to ensure that duties and trade remedies that are imposed on products from China are not subject to illegitimate evasion or circumvention. In addition, these policies will help ensure that any shifts to third country suppliers in response to duties on goods from China does not create a new conduit for imported goods that are distorted by China's non-market policies and transnational subsidies.

[45] *See id*. at Secs. 408, 511, 529, and 416.

[46] LTPFA 2.0 at Sec. 204.

PANEL II QUESTION AND ANSWER

COMMISSIONER GLAS: Thank you, Ms. Drake.

We are going to go in alphabetical order, so I will recognize Chairwoman Cleveland first.

CHAIRMAN CLEVELAND: Thank you.

And thank you all for your testimony. It's very, very helpful.

Ms. Ray, if I could start with you.

An earlier witness talked about Sinosure, which acts as an agent of the Chinese government when it comes to supporting Chinese companies.

And as Ms. Drake just pointed out, there's been a longstanding concern about the role of Chinese -- multiple Chinese banks that are heavily subsidized by the government in supporting China's BRI and "Going Out" policy.

I wonder if you could talk a little bit about the role of Sinosure and Chinese banks in Mexico and supporting companies that may be engaged in efforts to avoid tariffs or may be engaged in an effort to take advantage of Mexico's status?

COMMISSIONER GLAS: Microphone.

DR. RAY: Thank you for that great question.

Sinosure and like development finance institutions all over the world does provide guarantees and insurance for overseas investment.

This is the kind of thing that the PGI is particularly well positioned to compete with. That is, in fact, built into the design of PGI.

U.S. EXIM, in addition, provides the same kind of export credit support.

Similarly, when I refer to multilateral regional platforms like IDB Invest, it is specifically with an intent to be able to provide those services.

When U.S. EXIM, when IDB Invest, when PGI supports a project with subsidized credit with coordinated investment facilities, these are all ways that the U.S. and other G7 countries can step up our game in a similar way and can ensure that the resulting investments meet those domestic standards that are embodied in the USMCA principles.

I hope that helps.

Sinosure does, in fact, participate in subsidizing outbound credit and investment by providing insurance.

And that's exactly the same kind of thing that we provide through our export credit agencies that other G7 countries do as well.

And that's why I'm recommending that we use these multilateral as well as unilateral methods to continue to participate in this space and step up our own game.

CHAIRMAN CLEVELAND: I think Mr. Harris characterized Sinosure as engaging in ransom and hostage taking. And I'm not sure the EXIM Bank -- our EXIM Bank has done that. But I think what I'll do is follow up for the record to try and draw a contrast or try and develop an understanding of the difference in the contrast in your positions.

I'd also -- I'd like to sort of clarify, Mr. -- Dr. Malesky, I think your testimony is brilliant and really helpful in understanding the value for both Vietnam and the United States of investment and advancing what we have long, you know, we have been trying to develop as friend shoring.

And you make the point that there are social, employment, wage, and other benefits that derive from investment.

And that we have to be careful about, I think your words were mischaracterizing legitimate investment and exporting behavior as rerouting.

So, we should be cautious about that.

On the other hand, Ms. Drake, you sort of make the same point from a different perspective, which is that investment, capital equipment, and inputs from third countries are being intentionally used to -- by Chinese companies to evade AD and CVD concerns.

I'm trying to find the balance between a commitment to build up friends in a friend shoring strategy and ensure that China doesn't take advantage of that.

So, could you be specific in what are the metrics? What should we be looking at as the standards for characterizing something as rerouting and not in our interest versus supporting a friend and our Indo pact strategy that is trying to create a buffer, if you will, to China?

So, that's for Ms. Drake and Dr. Malesky.

DR. MALESKY: I'll start.

So, I think -- I actually think it's possible to do.

I do think that we can -- when we look at the data, we can see which products are being shipped in, which products are then being exported out.

We can look at it, we can connect that data to company data so we can see which of these companies are actually engaging in the activities.

And so, it's possible to pinpoint companies that are actually trying to evade the tariffs, if that we decide to do.

My caution was, sometimes -- and that's not here happening in this Commission, but sometimes in the policy debate that's taking place in the broader environment, people are using aggregate export and import data to make very large claims about behaviors that include companies actually shifting supply chains in, building new -- building companies, hiring workers.

And what's coming in as imports is actually intermediate goods and machinery which is positive for the Vietnamese investment environment, then, ultimately, positive for American consumers. But I do think it's possible to draw that distinction. I can get into some complications about matching data.

I know that Commissioner Wessel would like to talk about trade codes, but I think it's possible to do.

CHAIRMAN CLEVELAND: And Ms. Drake.

MS. DRAKE: Commissioner, I would say that I agree, there's a difference between simply rerouting or evasion circumvention on the one hand, and legitimate real investment on the other hand.

If we had stronger enforcement mechanisms in the U.S. to identify that evasion, identify that circumvention, and take action against it, not only would that be a positive in terms of creating incentives for legitimate investment in the third countries such as Vietnam, it would also build public confidence that, okay, imports from Vietnam are up, but we have a really good way of distinguishing between what is transshipment or circumvention versus what's legitimate investment, and that makes us feel better about the fact that this reflects legitimate investment.

And I would just make a further distinction that, even if there is legitimate investment to the extent that that reflects transnational subsidies or if those intermediate inputs, for example, are coming from a state-owned enterprise, are being provided at nonmarket prices, there should also be remedies that apply to that.

So, whatever legitimate investment is happening is actually on legitimate market terms that are not unfairly harming American producers and workers.

CHAIRMAN CLEVELAND: I very much agree with that last point.

In addition to concerns about illegal logging or forced labor, I, yes, I think even if it does good for Vietnam, there may be other issues at stake.

Thank you, sorry to go over time.

COMMISSIONER GLAS: Thank you.

Commissioner Friedberg?

COMMISSIONER FRIEDBERG: Thank you very much. And thank you for your testimony.

It seems to me that the real problem here is just the sheer magnitude of China's production and the extent to which we and other countries have become dependent on China for a whole array of manufactured products, and that the goal of our policy ought to be to encourage the disbursal of manufacturing capacity.

And so, we've heard about sort of a gradation of responses to the tariffs that have been imposed.

One is this mere rerouting relabeling, and, clearly, that's a problem.

But even Chinese investment in production facilities in other countries whether it's Mexico or Vietnam doesn't necessarily address this concern about dependence on Chinese production if most of the parts or all of the parts being put together in those factories actually are made in China.

So, isn't the goal or shouldn't the goal of U.S. policy actually be to encourage investment, whether it's by other countries or by the country itself, in autonomous, indigenous manufacturing capacity? Not just taking a bunch of two Chinese parts and putting them into something.

And how do you do that? Maybe Dr. Malesky, start with you?

DR. MALESKY: Yes, I think it's a great point.

And I think that's why, in my third recommendation, I didn't have enough time to expand upon it, I tried to highlight that Vietnamese domestic manufacturers have not been participating as much in these supply chains as they should be -- as they potentially could be.

In fact, Vietnamese domestic -- 60 percent of Vietnamese manufacturing exports are done by foreign firms. Right?

A lot by Samsung, a lot by Korean firms.

But very few Vietnamese domestic manufacturers are part of it.

And I think one thing we can do from a bilateral assistance point of view is help Vietnamese companies improve their productivity, connect to those supply chains, and eventually, be part of that exporting activity themselves.

But I think that's a process of, first, learning those activities from export suppliers like Samsung that have that type of expertise and then, eventually taking on those skills themselves. I think that would be the strategy that I would recommend.

I also think there's plenty of opportunity here for American companies, I mean, so that one of the big companies that moved its supply chain or is moving large portions of its supply chain is Apple. But not Apple itself, but the Taiwanese manufacturers that are part of Apple's supply chain.

And once again, connecting Vietnamese domestic producers of intermediate products and services to those would be hugely beneficial for Vietnam and the U.S.

DR. RAY: I would like to underline the response of Dr. Malesky and say that we see something similar happening in the Latin American context.

My testimony was centered on Mexico because that's primarily a country whose economy has been directed around being a part of the value chain with an eye toward the U.S. consumer for many years.

This has been built into NAFTA for 25 years. Right? For 30 years now.

But this is a region that tends to be very open and very dependent on relations with the whole world.

When we look at, for example, countries -- developing countries, the FTAs that they have.

If I'm not mistaken, Chile has more FTAs, bilateral free trade agreements, than any other developing country in the world.

These are countries who have built their growth strategies on being a part of global supply chains.

Within that strategy, linkages with domestic indigenous supply capacity, indigenous manufacturing capacity is always very tricky.

Because you have, in fact, structured an economy around openness rather than supports. This is exactly the kind of system where targeted interventions to help build linkages in particular countries where we'd like to see more indigenous capacity to be able to take advantage of this can be appropriate.

We probably won't see is those same countries being willing to alter their openness at all with global economies because they've built up over a generation now of economic growth and strategy around being a part of global value chains. The question is, how can they best benefit from being a part of that? And in an indigenous capacity way rather than simply being a source of conduits.

So, for example, when I think of the extraction and agricultural sectors of South America, I primarily think of sectors that rely on importing machinery from North America and perhaps agri-chemical inputs from Europe to be able to then export beef and soy and corn and wheat all over the world.

Closing off any of those doors might decimate that sector for an entire continent. But as you say, what we're really -- the friend sharing approach would involve building up domestic industrial -- production capacity so it's not simply a matter of benefitting from very volatile, unpredictable, and hard to build a strategy around trends of who is sending to whom in a particular year.

MS. DRAKE: Thank you, Commissioner.

Yes, the Commerce Department has a set of very strong anticircumvention rules that it uses to enforce AD/CVD orders for exactly this reason.

Where it makes its own determination whether a good has been subjected only to minor processing in a third country to change the country of origin.

And even if that qualifies as substantial transformation under customs rules, Commerce will take its own look and say, no, it's clear this was just a minor processing.

They'll compare the value—they do very sophisticated calculations—and this is clearly just to avoid the duties.

And if there are ways to enforce that more broadly to 301 duties in another context, that would be very helpful, as well would be a way to use our current duty regime to get at those inputs so that there's an incentive for the third country to include more domestic value content rather than simply nonmarket inputs that are not benefitting that country the way that, if they want to benefit that country, one would hope would occur.

COMMISSIONER FRIEDBERG: Thank you.

COMMISSIONER GLAS: Many thanks to all of you for your testimony here.

You know, I maybe have a few observations, and then, a question.

You know, I think the trajectory of how things have changed in terms of now Mexico being a top supplier to the United States in such a short period of time is just mind boggling to me.

And I think a lot of people read headlines and think, wow, maybe the Chinese are on the downward trajectory.

But it's a much more complicated picture. Right?

Because Chinese companies are investing in some of these other countries.

They may be circumventing some of the trade rules, the trade laws that are in place to take advantage.

UFLPA's in effect. We have 301. I mean, the world has changed pretty rapidly over the last few years.

And I'm just wondering if, when we get a Made in Vietnam label, or a Made in Mexico label, how much value is really made in Mexico and Vietnam?

I also wonder, because China has invested so substantially, how much value is going back to mainland China?

Meaning, not creating the kind of wealth opportunities?

I also am thinking, if China's investing in these countries, they're also bringing those same bad trade practices, not just circumventing AD/CVD potentially, but maybe even replicating some of the sort of bad behaviors.

I also wonder if the U.S. government has enough analysis that some of these Chinese firms who have invested in Mexico may be shell companies that manufacture a little, but are still importing finished product to make it to the United States market, claiming it's made in Mexico. So, given this rapidly changing environment, in your assessment, I'll start with you, Ms. Drake, do you feel that CBP and our agencies have enough information that they're tracking in order to really understand this dynamic?

We have USMCA in place, but to what extent are we sure that the value of the good actually meets not only the rules of origin -- and also what is the threat when mainland China may be getting most of the benefits for investing in some of these countries?

And do you think countries are aware -- if some of our friends are fully aware of some of the threats that may be facing them as a result?

MS. DRAKE: Thank you, Commissioner Glas.

Yes, certainly with the strengthening of the region value content rules in USMCA, customs has a lot more tools to ensure that the maximum amount of the value under those rules is being produced within the region and not merely being transferred from China or other countries outside of USMCA.

But there is a lot more that could be done. One of the concerns that I highlighted in my testimony is the de minimis provisions. And that, for example, in the AD/CVD context, the fact that all entries that are subject to AD/CVD have to be made through formal entry gives customs an amazing amount of information about each of those entries.

The importer of record, the foreign exporter, the ship that it came in on, it's just a huge amount of information that comes in on these forms.

And customs is able to use that data to create -- to conduct risk targeting and to create maps between different producers and importers and patterns in trade that help it identify when circumvention or evasion might be happening.

If imports are allowed to come in without that formal entry process, whether they're subject to 301 or not, because we know that China is, you know, a big source of the concern about use of these de minimis provisions, you're depriving customs of that tool, that information that allows them to do risk targeting and track and enforce, whether it's for duty purposes or simply for country of origin purposes or other transshipment purposes.

So, in my view, it would be vital to make sure that customs is collecting that information so that it can perform its enforcement duties.

COMMISSIONER GLAS: Thank you. Any further comments?

DR. RAY: I'll make my response brief because I think, actually, it's very interesting that, in the USMCA framework, we have, as Ms. Drake said, now our top import source is Mexico. And yet, as my Figure 2 in my written testimony shows, Mexican exports to the U.S. have not increased as share of global trade within those sectors targeted by the Section 301 tariffs. In other words, this may be a sign that the provisions of USMCA are adequately protecting from any rerouting or relabeling circumstances.

If that were the case, we would expect to see Mexico-U.S. exports specifically rise within those sectors as a share of global trade in those sectors. And we simply haven't seen that yet. In fact, of the $4 billion that I mentioned earlier of Chinese auto makers and truck makers announcements of building new in plants in Mexico, the majority of that are just a few lines of EVs and hybrids for the Mexican market because they're not sold in the U.S. and they won't be sold in the U.S. any time particularly soon.

And so, this comes back to the challenge of distinguishing when we're seeing greater investment be particularly an attempt to evade tariffs and when we're seeing just the normal expansion of trade relationships.

In these particular cases in the USMCA context, we're simply not seeing those exports come to the U.S. We haven't seen it yet. We're seeing an expansion of the Chinese market in Mexico in which the U.S. companies have not quite gotten to the same point of competing for the Mexican consumer. But we haven't yet seen evidence of that turning into exports.

So, USMCA may create a framework or an example that we can learn from of an agreement that has high regional value contents, labor value contents, has enforcement capabilities within labor. And so, if, for example, the labor content -- labor value content is being circumvented, that can now be enforced through the trade dispute mechanism. It's not a side agreement anymore. So, we have more capacity to ensure that this avenue isn't an avenue for that kind of circumvention.

And it may serve as an example vis-a-vis other trading partners. I am not a Vietnam expert. I will defer to you on that. And with that, I will pass it over to you.

COMMISSIONER GLAS: Yes, I'm sorry, I'm a little bit over on time, but we'll come back for a second round maybe we can --

Do you have something very quickly?

DR. MALESKY: I'll make it really quick.

I just want to alleviate your fears that most of the exports leaving Vietnam are not being done by Chinese firms.

And most of the -- a large portion of the exports are done by Japanese, Korean, Taiwanese, American companies.

And a lot of the movement of companies from China into Vietnam was those companies moving their supply chains in for production.

So, when we're -- those are the Intels and the Apples of the world are also -- were also negatively affected by the tariffs in China and have moved their product in.

So, when you see a Made in Vietnam label, I wouldn't necessarily think immediately that that is a Chinese product.

And I think we can actually, as I tried to point out, we can do a better job of pinpointing exactly where the rerouting is being done and where it's being done by Chinese companies. That can be done.

COMMISSIONER GLAS: Thank you.

My comment was more about the content of a particular item, but I get the point that you're raising.

Thank you so much. Commissioner Miller?

COMMISSIONER MILLER: Thank you. And thank you all for your testimonies. The Chinese-Vietnamese relationship is a particular interest of mine. So, I'd love to dive in a little deeper with Mr. Malesky.

We see the Vietnamese trade surplus going up. And it may be going up and up and up and up going forward which will bring with it some relief that there may be less dependence on China, but also a greater focus on domestic Vietnamese economic policy making. We saw a number of years ago the Treasury labeled Vietnam as being a currency manipulator. It wasn't labeled last year, but the focus will only increase for those countries that have rising trade surpluses vis-a-vis the United States.

My question is, what do you see as Vietnam's options in terms of dealing with this, particularly from a political angle, rising trade surplus of the United States in the coming years?

And I'm not asking you to get inside the head of a Vietnamese leader, but rather, what policy options are available to the Vietnamese economic leadership as they want to encourage these trends, but at the same time, realize that there is going to be a growing political sensitivity, including in this city right here about a rising trade surplus from the United States?

DR. MALESKY: Yes, and I mean, I think made more difficult by Vietnam's nonmarket economy status. Right?

So, I think Vietnam has had for a long time, as you know, they have had this notion of bamboo diplomacy of sort of triangulating between China and the United States because of the precarious position that they're in.

They have long seen the U.S. as a major potential partner for them, specifically because it would allow them to diversify and reduce their dependency on China.

And so, I think if you remember way back in the Trans-Pacific Partnership negotiations, Vietnam went way further than we might have expected in terms of changing labor policy and changing labor rights in order to meet U.S. conditions because they thought the U.S. market was so important to them.

So, I think -- so, this is a very challenging thing for Vietnam. I think that you would find that Vietnamese policy makers would be willing to work with you on some of the questions that we're talking about here today, that they have their own concerns about safety, about Chinese products.

And so, there's, I think, in some of the issues about Commerce Department enforcement, you might find Vietnamese partners willing to work with you.

I think on -- I, so, I mean, you brought it up, I think the nonmarket economy status does raise some challenges and there are options for Vietnam to --

You know, this always becomes an issue because, if a Vietnamese product threatens -- which is imported cheaply, even if it's done by private companies, even if it meets most of our standards for what we consider to be legitimate production and not dumping, it's always possible for them to be flagged for this issue.

And then, but I think there are now, you know, through -- it has an unfortunate name, but PMS, that they can actually find a way to do this on a product by product basis is what they're looking for here.

Yes, I mean, in terms of the larger issue of Vietnam's relationship with China, why don't we -- I'll leave this, but we can come back to this in another question about how to manage that as well.

COMMISSIONER MILLER: So then, I want to follow up with a question from the other angle. Once upon a time, China was looking over its shoulder at Vietnam, at Mexico, at other countries, wondering who was going to be the next China.

Right now, in Vietnam, in Mexico, who are they looking at as being the next Vietnam or Mexico? And how close is this to being a reality in the short or even medium term if things were to go awry in the relationships with Vietnam or Mexico?

Either one of you.

DR. MALESKY: Yes, I mean, so, in terms of this type of production, you know, so, the countries that were alongside it by Vietnam or who had the potential to replace it in this space would have been Bangladesh or Myanmar.

But I think both of them are not in a position to be able to do this anymore. I think Vietnam is a much more stable environment for foreign investors.

I mean, there still are other countries in the region, Thailand, Indonesia, also. But I think Vietnam is better positioned than most other countries in the region in that space right now. So, I think when I talk to foreign investors, when they look for analogies, they pay attention to Vietnam's demographic bonus which is sort of leading right now, the percentage of the young people in the labor force. And they look at Sub-Saharan Africa because it's entering its demographic bonus. And so, they say, well, that -- this might be the opportunity.

But that doesn't have -- when you make that analogy, it's purely based on demographics and it's not based on the institutions or literacy rates or productivity that Vietnam had at the time.

DR. RAY: I'll just briefly say that I think Mexico sees Mexico as the next Mexico. With the growth of Mexican-U.S. exports in the last few years outside of these tariffs -- as I said, within the tariff codes, we don't see a big jump in Mexico-U.S. exports. But in general, we do.

And we see competition now beginning to heat up for the consumer market in Mexico for EVs, for hybrid vehicles. Mexico, since the enacting of NAFTA, has developed enough manufacturing capacity domestically in the auto parts sector and in the automobile sector to become a rising superpower when it comes specifically to just that one little sector of the global value chain, just automobiles, just cargo vehicles. To be a place that will specialize in that sector. I don't think that they're looking over their shoulder at any other parties.

And so, I think, given the fact that, while it may be too soon to say, USMCA is working, what we may be able to say currently we don't see an increase in Mexico-U.S. exports. We see an increase in Mexican manufacturing for the Mexican market. And this raises questions, well, what's our best policy response to that?

Because it's not just the U.S. market they're serving, it's their own market. How do we best compete for that market? And how do we encourage best practices when they compete for our market? And how do your firms benefit for the competition in both? Rather than thinking of any Central American or Caribbean country is likely to take over that spot.

South American countries are also building up capacity in that sector. But again, it's for domestic markets, because Brazil, Argentina, Chile, these countries have diversified enough economic basis and broad middle-class consumer populations that are the buyers for these products, and it's not as tied into the U.S. consumer market.

COMMISSIONER MILLER: Thank you, that's very helpful.

COMMISSIONER GLAS: Commissioner Price?

VICE CHAIR PRICE: Thank you all for your testimony today. I am going to ask an overly simplistic question that you, as good academics, are going to give a lot of caveats to, which I just want to make sure I'm reading through the lines of all of your testimony correctly. Again, it's overly simplistic and it's the kind of political question that you -- we've tried to avoid.

But do you see the tariffs as having the desired effect? Would you characterize them as successful or failure? Just your best answer to that.

MS. DRAKE: I'm not an academic, so I'm happy to answer a question like that.

VICE CHAIR PRICE: Okay.

(Laughter.)

MS. DRAKE: I believe that the Section 301 tariffs have been successful in reducing our reliance on China and reducing imports from China, reducing our trade deficit with China, resulting in some increased investment and production in the United States and in friendly countries.

But I think that it is vital that we apply stronger enforcement mechanisms to make sure that those duties continue to have those effects and that they do not simply result in rerouting or that they do not permit these same Chinese practices that are the concern that led to the imposition of the duties to simply be transmitted to the U.S. market through investment in third countries and imports from those countries.

So, I also think they provide an important source of leverage for the United States in trying to address China's policies whether it's on intellectual property and technology transfer, it's still -- that leverage has been used in some cases effectively.

And I think that it would be premature to say, well, just because Vietnam is also benefitting, we should get rid of these tariffs.

I think that we need to keep them there, but we need to strengthen the enforcement to make sure they are meeting their goals as well as they can.

DR. RAY: I'll chime briefly to say that rather than thinking about the direction of change, I'll think about the speed of change.

Specifically, I'm thinking of the January hearing that the U.S. Trade Reps Office had with industry and labor representatives from the automotive sector specifically talking about the IRA, that you could generalize through these tariffs as well within the automotive and motor vehicle sector.

In this hearing, representatives of industry groups were asking for greater flexibility to be able to compete on the global level and lower their costs. Representatives from labor were asking for continued protections to be able to make sure that their constituencies were able to maintain their participation in these value chains.

But both of them agreed, if my viewing and reading of the situation is correct, both of them agreed that it's important to be able to announce any changes with enough time to be able to prepare. Both of those constituencies were there.

And I would say the same thing goes for these tariffs and the third countries that are involved. Because there's enough volatility that these countries face on a day to day basis simply from currency markets or the prices of the commodities that they traditionally export.
But having the stability of the fact that these tariffs have remained relatively constant for the last several years has enabled an environment to be built up around an expectation that they'll continue.

And so, rather than thinking of the direction of the change, I'd like to say that the speed with which they have slowed or created a new normal, if you will, rather than an expectation of the unexpected happening at any time or general volatility, can be helpful for those third countries trying to develop domestic industrial capacity as Commissioner Friedberg said. That if they're going to benefit and not simply be reliant on one foreign power or another, that's really crucial. Thanks.

DR. MALESKY: Yes, so, I agree with everything my colleagues have said up here in terms of the benefits of reducing U.S. dependency and in terms of shifting Chinese trade patterns to other countries. I will say, and this is the premise I would add, that I think we all know that tariffs are a not so hidden tax on American consumers and not so hidden tax on American companies that rely on inputs for their products, that the other countries that have benefitted from this cannot replace the amount of trade that was coming from China. And I think, you know, sensitivity to that in terms of thinking about exemptions on those products or thinking about alleviation for those who were negatively affected by it is an important part of this consideration.

COMMISSIONER GLAS: Thank you. Commissioner Schriver, are you there? I think he may be -- we'll come back. Commissioner Sims?

COMMISSIONER SIMS: Thank you all for your testimony today. I'm learning a lot. One of the things that I've noticed in the conversation around Section 301 tariffs is a focus on what China has done, I guess, for lack of a better word, offensively to come back at us. And what I saw in the intelligence community was an increased sophistication from the Chinese government about how to get asymmetric impact on their responses, not just in the national security space, but economically as well -- not just economically, but also politically.

But one thing that I'm -- I would be curious to get your perspective on that I haven't heard a lot of conversation about is what China is doing from a policy perspective inside their country to prop up some of the companies that they have that are the targets of these 301 tariffs. I'd love to hear from any of you that have a perspective on that.

DR. MALESKY: I can speak to this a little bit.
I mean, I'm not an expert on this so much, but I think we've heard from other panelists, and I think it's pretty well known that there is, for companies that have been targets, there's been subsidies that have come from state owned banks, that there has been cross subsidization from state owned enterprises, that targeted companies in one product line were able to help out other product lines of their same supplies.

So, in that -- and I think that that has been a coordinated effort that has involved Chinese officials.

I'm not -- Sinosure has come up a lot here. I'm not very familiar with those activities so much. But definitely in terms of state banks, and state-owned enterprise activity, we've definitely seen.

MS. DRAKE: I would just second that, that you do see when a Chinese company that, let's say, was the lead exporter of X product that gets hit with duties, then makes an investment in a third country to produce the product there and send it to the U.S. to avoid the duties, they do continue to benefit from the same China state-owned bank support. And maybe even additional support as part of the "Going Out" policy. The difference for U.S. producers that are facing that is that, we can get at those subsidies when the products are coming from China.

Under our current system, we cannot get at those subsidies when the product is coming from Vietnam. So, it's a huge gap in our policies that needs to be updated to respond and adapted to respond to what the Chinese government is doing. The traditional idea is, why would a government ever send a subsidy to a producer in another country? Well, now we see the Chinese government doing that all the time. And so, our laws and our policies need to be updated to deal with that threat.

COMMISSIONER SIMS: On another topic, what areas of national security concern, such as medicine, PPE, things of that nature, are we seeing China reroute to try to mask, you know, where it's really coming from? Does that make sense? Are we seeing that happen a lot? Do we have any specific examples of it that you've seen?

DR. RAY: I'll just say that we don't see a lot of that going through the Mexican market. We may see a different scenario with Vietnam. So with that, I'll put you on the hot seat, if you don't mind.

DR. MALESKY: Thank you. So, I mean, as I said, the findings are preliminary. We're trying to pinpoint it, as I said, in the written report. We're looking at the six-digit HS codes to see what companies are importing in and then what they're exporting out and to see if there's been any change in value added while it's been in Vietnam, and that's not easy to do. But I can say that the places where it appears to be happening, I'll leave it to you to tell me whether there's a national security issue here, but it does seem to be some light electronics, some computer activities; and then, yes, I would say the area where we mostly see it has to be pumps, electronics, computers. That seems to be the area.

I'm sure that there are secondary national security issues that are involved there that would need to be looked into, but I wouldn't know specifically what they are.

COMMISSIONER SIMS: So shifting from kind of imports to the export perspective, how could offshore subsidiaries of Chinese companies be used to get around export controls around sensitive technology?

DR. MALESKY: I mean, I think the very same processes that we're talking about here, right, which is why I think it is important to figure out exactly which companies are doing this. But the export controls that are targeted specifically at a geographic area can be evaded by moving those products through production in other places. And I'd say it doesn't just have to be companies that are specifically getting most of their capital from China. I mean, this can also take place through other partnerships, as well.

COMMISSIONER GLAS: Commissioner Wessel.

COMMISSIONER WESSEL: Thank you all. Thank you for the research you're doing and the work you do, Elizabeth. You know, Ms. Ray, I do want to provide a cautionary note, though, because I think the jury is still out on what's happening in Mexico. You refer to the LVC, et cetera. I don't think any of the LVC data has been released. I think, as it relates to the RVC, there have been questions about its implementation. We could go through a number of other areas that I'm sure you're aware, the steel and aluminum surge and ongoing disagreements.

But that jury will sit again in two years or two and a half years. President Trump and Congress were wise enough to put a review-clause period into the USMCA, so your work and that of others, you know, I'm hoping is going to bear fruit to be able to do the proper review and determine whether the benefits that people had wanted to accrue to U.S., Mexico, and the North American market, in fact, take place. And this is not simply China finding a new avenue to reach the U.S. consumer. So the jury is out, but I do appreciate the directional input.

Ms. Drake, I want to ask you a question because -- and you are much more expert on the law than I am. But I've been re-reading the statute regarding de minimis, and it seems that it only authorizes CBP to provide de minimis; it does not require that CBP act in that way. Today, across a number of panels, we've raised questions about de minimis and its impact, whether it's on product safety -- we've heard in the past about fentanyl and many other things.

Can you help us understand whether legislation is needed? You know, the administration pushes and said, you know, it's their job. I read the statute and sort of think they have enormous authority to do a lot of this on their own. Can you help educate us?

MS. DRAKE: Thank you, Commissioner Wessel. I read the statute in the exact same way, that all it does is authorize Customs to accord de minimis treatment. It does not require that it do that. The statute also explicitly says that Customs can grant any exceptions from de minimis treatment in order to protect the revenue or to ensure the effective enforcement of import regulations, which would deal with all of the health and safety, the Uyghur Forced Labor, all of the import regulations of fentanyl, all of the imports that may be violating those regulations. So there's no new legislation needed.

The way I read the regulations, there's also no new regulations needed. Customs already, in its regulations, says the same thing that it says in the statute, that it already has the discretion to deny de minimis treatment in order to protect the revenue or to ensure the effective enforcement of import admissibility standards. So there's no need for a long notice and comment rulemaking. Customs could simply say our new policy is this, and put out the policy; and, in fact, that's what they do in the de minimis context all the time. They'll put out Customs rulings, which are basically kind of policy statements from Customs, saying this is how we're going to decide if it's one shipment or more than one shipment, this is how we're going to decide if it's above $800 or below $800.

They could do the exact same thing to say, administratively, they said, okay, this is AD/CVD duties are not going to be eligible for de minimis. They could do the same for 301 duties, 232 duties, imports that pose risks in terms of public health and safety, or other concerns. So, Customs absolutely has the authority to do that right now under the current legislation, current statute, and current regulations.

COMMISSIONER WESSEL: Well, that sort of eliminates other questions I have because that seems to be pretty clear on that. So, thank you for that.

Let me ask our two researchers, our two academics, what other information would you like to see, and you don't have to give this all to us now, but what data sets, what information will allow you to do a deeper dive? Mr. Malesky, you talked about my focus on HTS codes, and I do often go down to the ten-digit level. But we have the MNE report that comes out every year. It's a two-year delay, as I recall. Commerce has the power to compel in terms of questionnaires about any company that does business in the U.S., whether it's U.S. headquartered or not. And, again, quick answer or in writing, what data sets, what kind of access do you need to do your job to help us and help other policymakers really understand what's happening?

DR. MALESKY: The hardest one is alignment of product industrial codes. So the biggest issue that we have --

COMMISSIONER WESSEL: I'm sorry. When you say it, do you mean NAICS?

DR. MALESKY: Yes. So HTS versus HS versus --

COMMISSIONER WESSEL: Right, right, right. Okay.

DR. MALESKY: Yes. So, the tariff data is at the eight-digit or ten-digit HTS. The Customs data is at the six-digit HS. And then Vietnamese firms, in the industrial survey, it's at the four-digit ISIC. And these don't perfectly align, right, so I'll lay out the problem for you. So, what happens is I can say I see a product going in and out at six digits, but that actually, that one six-digit code might include several underlying products that, you know, of 20 eight-digits within the --

COMMISSIONER WESSEL: Is that something that could be fixed?

DR. MALESKY: Yes. I think we can get at it. I think it would just, it would take some effort and some researchers to get together to have better conversion tables between these. And then --

COMMISSIONER WESSEL: And it would also have to be international, so it's not just a U.S. --

DR. MALESKY: It would have to be, yes, but I think we could figure it out and especially when looking at the U.S. tariff products. That would be very helpful to do because we make an assumption, and that's why I keep on saying this is preliminary that's really important, is when we see a tariff on one of the underlying products that's at the ten-digit level within the six digit, we say we either do the share of the six-digit product that we observe in tariffs at the eight or ten-digit level or we say we code the entire six-digit product as a tariff product because any one underlying product, and it is. And so -- we just are not perfectly able to pin down how much value added is taking place in Vietnam. So that would be the first one.

And then the second one is, when we do match it to companies, we can figure out -- this idea that being able to compel surveys of investors and, to get at Commissioner Glas's question about local content and Chinese content, would then be the next very helpful step in being able to pin it down better.

So those would be my two suggestions. And I think it would take a task force to be able to work on of academics, but it would be, I think, one that would be immediately helpful for solving this problem.

COMMISSIONER WESSEL: The first idea would take the task force. The second --

DR. MALESKY: The second one would not.

COMMISSIONER WESSEL: -- existing statutory authority, and that's the stroke of a pen by the Commerce Secretary.

DR. MALESKY: Right. But I think, after academics pinpointed where exactly the activity might be taking place and who might be responsible for it -- it doesn't have to be academics, but someone with a computer, right, yes.

(Laughter.)

COMMISSIONER WESSEL: I understand.

DR. RAY: I would agree with all of that and simply add NAICS to the list of correspondence tables. I agree with you entirely that the jury is still out about USMCA. As I said earlier, it is too early to say if USMCA is being successful. But one of the reasons why my recommendations aim towards enforcement and softer methods like cooperation is because opening the provisions themselves won't really be a viable option until we get to this review period. And when that happens, I certainly am hoping that we'll get to see that data on labor and regional value content to be able to make actually unbiased, clear-eyed analyses of how well it's working. So that's the other ask, I would say.

COMMISSIONER WESSEL: Thank you.

COMMISSIONER GLAS: Thank you all so much. We do have a couple of minutes for any additional questions. Do we have any?

CHAIRMAN CLEVELAND: I'd like to ask one.

COMMISSIONER GLAS: Yes. Commissioner Cleveland.

CHAIRMAN CLEVELAND: Thank you. Dr. Ray, the next panel has a witness who did a nice succinct list of China's approach -- industrial policy approach, and talked about a partial list of policies that we should look at as we consider rerouting, transshipment, and some of the other concerns raised today. A partial list would be the credit China state-owned banks offer their firms, subsidies to firms for the purchase of machinery, subsidies to firms for generating patents or achieving other innovation benchmarks, letting firms buy or rent land at discounted prices, transfer of technology, and then bans or limitations on raw materials.

I wonder, as you look at Mexico separate and apart from the specifics on rerouting, given your expertise on Latin America, do you see evidence of these practices that the Chinese Communist Party is engaged in with Chinese state-owned enterprises largely and Chinese companies, do you see evidence of those companies investing in Mexico?

DR. RAY: When I look at specifically those kinds of industrial policies, there's a long history of them domestically within Latin America, as well, but those are favoring Latin American companies or Latin American state-owned enterprises. When I think about one of the most important industrial policies that we've had in the last few years is the IRA. This specifically will start limiting the imports of critical minerals for batteries for EVs next year, I believe. Mexico is in the process of considering whether it will nationalize its lithium resources. If it does so, it will be creating its own state-owned enterprise specifically for lithium and will be managing everything through that. But this is not necessarily because of influence from the Chinese way of doing business but, rather, an imitation of what Mexico did with petroleum in the 1940s. And so, this is one more reason why I emphasize the importance of maintaining those communications open with our counterparts in the Mexican government so, whatever the rules of the game are, we're all enforcing the same standards with it.

I have not seen, for example, Chinese state-owned enterprises particularly active in the EV sector or hybrid auto sector in Mexico. These are private firms that I'm talking about doing the investments in Mexico, and the critical minerals that will be part of the supply chain for batteries, those are likely to end up being Mexican indigenous companies. There was a Chinese state-owned enterprise that was investing in Mexican lithium, but it's actually frozen that investment because of the potential for nationalization.

So the jury is, again, very much still out on which direction this will go, which is why my recommendations are so focused on enforcement of standards and maintaining open lines of communication while things settle out.

CHAIRMAN CLEVELAND: But I think you've chosen to focus on, because it's consequential, the car market. I'm interested in, for example, China, in Mexico, has done what it's done elsewhere, which is to invest in an oil refinery project, I think. I guess this is going back to what Commissioner Glas raised, which is there is reason to have concern about Chinese practices, as they've engaged previously, how Chinese practices will be carried out in their investments in places like Mexico and Vietnam, and how do we get at Ms. Drake's question, which is, if they're subsidizing in China and they move the enterprise to Mexico or invest in an oil refinery in Mexico and that oil is then exported, how do we attack that problem, or evaluate that problem may be a better way to put it?

DR. RAY: Within the energy sector in Mexico in general, beyond vehicles, when we're talking about petroleum, natural gas, oil refineries, this is a sector that is heavily unionized and heavily impacted by state-participation of the Mexican government, not a sector that is characterized usually by a lot of dynamism but, rather, a lot of buying stability through participation of unions and state-owned enterprises. And so in that regard, it's unlikely for -- I'm not an expert on the oil sector in Mexico in particular, but I will say that, from my observations from the outside, it's unlikely to see a lot of outside firms being able to change that intrinsic characteristic of the last 80 years of oil production and refining in Mexico, which has been characterized mostly by trying to achieve stability, rather than trying to achieve growth at all costs, which is where you begin to see evasion of standards, pushing down standards, or trying to import practices from elsewhere. Since Lázaro Cárdenas in the 1940s nationalized that sector, we've really seen a sector built around stability and participation more than growth.

COMMISSIONER GLAS: Commissioner Friedberg had a question.

COMMISSIONER FRIEDBERG: Yes. Back on this question of dispersal of industrial capacity and the role that foreign countries investing in third places, Mexico, Vietnam, or wherever, can play in either assisting that or resisting it, I wondered if you had any observations about whether the behavior of Chinese companies in Mexico or Vietnam or other parts of the developing world is different in any way from Japanese or Korean or American companies. And I'm thinking particularly about technology transfer, know-how, worker training, the role of local people in management of these companies, and so on.

DR. MALESKY: It's a very challenging question. Whatever I'm going to say, I'm sure there's people, maybe people are watching online that will immediately find contradictions to everything I'm going to say.

So when Commissioner Cleveland was asking her question, I was thinking the first thing to understand is that entering these third parties are three sort of -- to generalize broadly, three different types of Chinese foreign investors, so Chinese state-owned enterprises who we know are state-owned enterprises and then are moving in and they're invested as state-owned enterprises.

But the second is there are two types of private companies, right, so Chinese private companies that have some connections, rely on state capital, get cheap subsidies. Some of them might be very big, but some of them might be small. And they are entering these third parties. And then the third one is small unconnected Chinese manufacturers that are not relying on state capital that maybe even rely on private capital or own source capital that are entering. There's a lot of them, and a lot of them are very small and they're not necessarily part of this larger, you know, sort of plan that we describe sometimes, right. So that's the first thing I'd say about that.

The second thing is how do they differ. So one of the major issues that has occurred occasionally in Vietnam is Chinese companies relying on their own labor, moving their own employees in to produce, sometimes in violation of Vietnamese labor law, which has created some issues there. So that has been one that's been very different. I mean, other companies may rely on other experts, but Chinese moving in large portions of labor to work in, say, aluminum mines or something like that has been a big issue about that.

The second is, and I'll say this, you know, I do large surveys in Vietnam. I monitor levels of corruption, right, you know. It is much more a part of normal business practices to be able to use corruption, to be able to avoid regulatory issues, to be able to engage in procurement. I think you would find that Chinese companies are much more comfortable with those types of activities than other foreign firms. So that would be the two ones that immediately spring to mind.

And the third one, as I would say, is regulatory compliance and their views about regulatory compliance and how much they comply with labor standards, environmental standards. And I think, once again, if you spent some time, they would vary across those three different types of companies that are characterized above.

MS. DRAKE: May I, just very quickly. I'm sure that Dr. Ray also would like to add. One difference that we see is that Chinese firms, particularly state-owned or those with state backing, when they're operating in third countries, are not necessarily operating on commercial terms. So just the fact that they're in a market economy doesn't mean they're acting like market economy actors, and so they may still be relying on subsidies. They may not be engaged in pricing behavior or production decisions that are based on market fundamentals. We see such an aggressive focus on continuing to access the U.S. market, even to the extent that they are exporting equipment and raw materials to the third country for free, for no cost, just to maintain that relationship. And that was covered in my testimony, and I think that's one of the reasons when we looked at 45 affirmative evasion determinations, 44 were on products from China. That's way out of whack with the number of orders that they account for.

DR. RAY: I think you're asking exactly the right question: how is their performance relative to other investors in those same environments. And that's a question that I lead-edited a book on 2015 on with colleagues throughout Latin America looking at the most important Chinese investment in the most important sectors compared to Western investors in those same sectors in those same countries with research partners throughout eight countries in Latin America. And what we found was, overwhelmingly, the same Chinese firm would have different ESG performance in different countries to match what was required to do business in that country because it is -- particularly for state-owned enterprises who saw this as a state-to-state relationship. And this is why I say states actually have significant policy space and latitude to set the rules of the game, because we saw Chinese firms being willing to live up to or down to the standards as they were in a given country.

Sinopec, the Chinese SOE oil giant, had very different performance levels in Ecuador, Colombia, and Argentina, three different -- very different countries where we tracked their performance. And so this is another reason why I emphasize the importance of soft measures, such as institutional capacity for enforcement because host countries have the power to set the policies, but do they have the power to enforce those policies is still a question that remains to be answered.

COMMISSIONER GLAS: I just, I don't want to overextend this panel, just a brief question. Well, all these questions are complicated and greatly appreciate your time, but it strikes me that Congress is going to be doing a Customs reauthorization bill in the next year or so, depending, and, you know, given the velocity of how things are changing, there's still a lot of made in China products that are sent to the United States from manufactured in China, mostly of Chinese components. Now it's a little more complicated. Lots of Chinese investments in places like Mexico, Vietnam, and throughout the world.

You know, do we see a Customs agency seeing an onslaught of imports, some where they have information, some where they don't, and a retiring workforce here in the federal government. And knowing the risk assessment that we've all discussed today around consumer product safety and also the other implications to manufacturing, counterfeit, et cetera, et cetera, what would your recommendations be to bolster Customs' ability to track information in the global environment to better understand what is happening in some of these countries, to better target data sets, things like that, based on your experience?

MS. DRAKE: Well, one recommendation that I would have would be to create more formal and transparent mechanisms that require Customs to engage with the private sector. This is through our experience with the Enforce and Protect Act where Customs was very reluctant to open up the enforcement process to domestic producers and petitioners and said, no, we're the experts, we're the law guys, and we're going to enforce the law, we don't need your help. Now, a few years later, Customs has totally done a 180 and said this is great, this is incredibly helpful that we're able to get private information, we're able to have formal investigation procedures, share information, and identify over a billion dollars of lost duties. So that should be expanded to beyond just the AD/CVD context.

The bill of lading data that Dr. Malesky relies on is one example where we allow importers to withhold their information from that data, and there are other exceptions to the data. We, as petitioners, use that data all the time, the very same service that he uses, to try to identify circumvention and evasion. So that data should be robust, it should be available broadly, it should have wider coverage, and that would help the private sector engage with Customs to deal with the fact that they are resource constrained, but there are a lot of domestic producers and workers that want to help.

COMMISSIONER GLAS: Thank you so much. I think that is the conclusion of this panel. Thank you all for being here today. We found your testimony extremely valuable. We are going to take a break for ten minutes and then start with our last panel. Thanks again.
(Whereupon, the above entitled matter went off the record at 2:30 p.m. and resumed at 2:40 p.m.)

PANEL III INTRODUCTION BY CHAIRMAN ROBIN CLEVELAND

COMMISSIONER GLAS: Chairwoman Cleveland.

CHAIRMAN CLEVELAND: All set? Great. Our third panel today will assess the Chinese government's economic and policy support for its domestic manufacturing sector and consider the potential impact of these policies on the United States and China.

We'll start with Dr. Gordon Hanson, Peter Wertheim Professor in Urban Policy at Harvard Kennedy School, who will address China's changing competitive advantages in its manufacturing sectors and long-term barriers to productivity growth.

Next, we'll hear from Mr. François Chimits -- I hope I said your name correctly -- an analyst at MERICS and researcher at CEPII. We will discuss how their Little Giants program represents a recalibration in Beijing's approach to industrial policy and its increased emphasis on supporting innovative small- and medium-sized enterprises.

And, finally, we'll hear from Mr. Adam Wolfe, Emerging Markets Economist at Absolute Strategy Research, who will discuss how worsening internal and external economic conditions have led Beijing to prioritize its manufacturing sector as a driver of growth and resiliency and why he thinks it might fail, based on the testimony I read.

We all thank you for your testimony and ask, as always, for the witnesses to keep your statements to ten minutes so that we have ample time to engage in discussion.

So with that, we'll turn to you, Dr. Hanson.

OPENING STATEMENT OF GORDON HANSON, PETER WERTHEIM PROFESSOR IN URBAN POLICY, HARVARD KENNEDY SCHOOL

DR. HANSON: Thank you very much. And I do see the seven-minute marker, not the ten-minute marker. Thank you to the commissioners for the opportunity to be with you today and to the staff of the commission for organizing this event. What I'd like to talk about is China's status as the world's dominant export manufacturer, a bit about how it got there, where it's going, and then what the U.S. should do about it.

So just to begin, to take a step back and think about how we got to today, China's emergence as the world's factory we view as something that China engineered. I think there's an important counterargument to consider there in how much of this was a natural process of economic growth and development in a very large economy that had really one resource to share with the rest of the world, and that was its labor supply.

So China's initial specialization in labor-intensive manufacturing in which it became the dominant factor globally in the space of less than ten years is a process that wasn't that different from what Singapore and Hong Kong and Taiwan and South Korea had done 20 years before. It just happened more quickly, and it happened on a much bigger scale.

So what this means is that, as we think about where China is going from here, we're coming out of the period in which that initial phase of development was fairly preordained by the fact that China had all this labor and not much else. Now, as we move in to the next phase, its industrial policy begins to play a much more significant role.

When we think about the policies that have been most consequential for China, it's important to keep in mind that what are probably the most significant policy choices that China made are ones that had the U.S. support. The biggest factors that helped drive China's dominance in labor-intensive manufacturing, clothes and shoes and toys and games and then moving into consumer electronics, was, first, letting in foreign direct investment in the early 1990s; second, allowing labor to move from farms to factories, relaxing controls on internal migration; and, third, allowing the private sector to grow. U.S. is in support of all of those things.

Now, China also supported the stealing of intellectual property and the targeted use of industrial policy to help particular industries. And those have obviously run against U.S. interests and not something we supported. They are less important in terms of China's overall presence in manufacturing than those other policies.

Now, those policies were cemented in place by China's agreement to join the WTO. That helped remove the set of the policy apparatus that was still in place after three or four decades of central planning, limits on what China could export, limits on -- continuing limits on what foreign investors can do in the country. And joining the WTO obligated China to remove those restrictions. We were behind that. So that is backdrop.

As we look forward to where China is going to go from here, it faces a very disquieting fact, and that is the easy growth, the rapid increase in its overall productivity that it enjoyed from the early mid-1990s to the end of the 2010s, was a one-off experience in its economic history. It was a consequence of going from Maoist central planning to something that's not market-oriented but a lot more market-oriented than it used to, being able to take technology off the shelf from the rest of the world and apply that to its industry, and to be able to redeploy labor from agriculture to industry where the Maoist idea was that farms should come first.

That led to a productivity miracle the likes of which we haven't really seen. That productivity miracle came to a definitive end somewhere around 2010 - 2012. And since that moment in time, China has not been able to re-engineer it. The consequence of that has been China not receding any territory in terms of its position in global markets, holding on to its market shares in various sectors, but not taking over market share in general the way it had in the earlier decades.

Now, there's some important exceptions to this: what China has done in automobiles, what China has done in solar panels. But its overall presence in manufacturing on the world stage has been pretty stable for more than a decade now.

As China now enters this more mature phase of growth, among the most significant policies that are directing that growth, aside from its targeted industrial policies, is the way in which it has hugely expanded its higher education sector. In the space of less than ten years, China increased the number of college graduates by a factor of seven. Many of those colleges graduates were coming from substandard universities, but enough of them were not to change the pace of innovation in certain frontier industries. That has opened the door for China to move on from clothing and shoes and toys and games into cell phones and laptop computers first and now into higher-tech manufacturing.

Here, again, the U.S. is playing a role in helping that transition in China. The tariffs we put in place beginning in 2018 and that have been kept in place have made it particularly hard for China to hold on to the most price-sensitive sectors in which it had developed dominance, and that's the labor-intensive stuff. That's the clothing and shoes and toys and games. Keeping those tariffs in place ensures that China is going to continue to push towards electronics and higher-end electronics.

So we're at a bit of a juncture here in terms of where China goes. The U.S. maintains high barriers to imports from China. We're going to reinforce that incentive for China to move in to higher-end manufacturing, whether that's our intention or not. If we wanted to keep China, to create more pressure on China to stay in some of its traditional manufacturing industries, then lowering tariffs, unpopular as that is in many quarters, is probably the most direct means the U.S. has in order to do so.

Turning the table to think about China to then think about maintaining the U.S. supply of these labor-intensive goods, if we're not going to get them from China, where might we get them, the big untapped potential comes from South Asia, comes from India and Pakistan. India and Pakistan have the potential to take over China's role in the supply chains it has dominated, but it requires them liberalizing their economies in a way they have not been able to do to date. The U.S. can play a significant role in encouraging that liberalization. Thank you very much.

PREPARED STATEMENT OF GORDON HANSON, PETER WERTHEIM PROFESSOR IN URBAN POLICY, HARVARD KENNEDY SCHOOL

Testimony before the U.S.-China Economic and Security Review Commission

Hearing on Consumer Products from China: Safety, Regulations, and Supply Chains

March 1, 2024

Gordon H. Hanson, Harvard University

1. Introduction

Over the last three decades, China has emerged as a global industrial powerhouse. The spectacular growth of the country's manufacturing sector has turned the nation into the world's factory. Initially, much of this growth was based on labor-intensive manufactured goods, such as apparel, footwear, furniture, and consumer electronics. China has since diversified into more technologically advanced products, such as cellphones, laptops, solar panels, semiconductors, and electric vehicles. Although China remains the world's largest exporter of manufactured goods, its period of rapid growth ended more than a decade ago. Today, China is a lumbering economic giant, beset by the inevitable growth slowdown that follows a period of rapid economic opening, policy choices that have undermined the foundation of the country's earlier growth, and rising barriers to its access to foreign capital, markets, and technology. In this testimony, I discuss the origins of China's export manufacturing boom, the reasons behind China's recent move into technologically advanced manufacturing, prospects for continued growth in China's manufacturing sector, and policy options facing the United States.

2. China's Export Boom

One can divide China's export development into three phases, based on its varying pattern of industrial specialization and policies governing international trade and industrial production.

2.1 Initiation of Export Growth: Rise of Export Processing (1992-2001)

China's manufacturing export boom began in earnest in 1992, when Deng Xiaoping expanded the country's process of "reform and opening" to encompass export-led development (Vogel, 2011). Production for foreign markets, often in processing plants owned by or subcontracting for multinational firms, mushroomed in special enterprise zones allowed to operate in select southeastern coastal cities, before being allowed to spread throughout the country (Yu, 2015; Chen et al., 2019). China's embrace of manufacturing as its engine of growth was a conscious attempt to emulate the success of Japan, Singapore, and South Korea in previous decades. Indeed, Singapore's long-serving Prime Minister Lee Kuan Yew was an informal adviser to Deng during the period in which Deng crafted his reform strategy (Vogel, 2011).

Because of China's long history of central planning, the reform process was complex. It entailed allowing foreign firms to invest in the country and to import foreign machinery and technology (Yu, 2015), creating a more market friendly commercial legal system for firms operating in special enterprise zones (Feenstra and Hanson, 2005), dismantling a system of foreign trading rights in which most firms were required to export through state-owned intermediaries (Bai et al., 2017), consolidating and closing smaller, inefficient state-owned enterprises (Hsieh and Song, 2015), lowering import barriers (Brandt and Morrow, 2017), and relaxing restrictions on internal migration that were embodied in the country's hukou registration system (Fan, 2019). Central to China's export growth was the country's insertion into global value chains, in which export-processing plants in China assembled outputs from imported inputs. Many of these production chains were orchestrated by multinational enterprises based in Hong Kong and Taiwan, with companies from South Korea and Japan also making major investments in the country.

Although Deng's reforms contributed to the rapid expansion of China's export base, the country maintained many barriers global trade and investment. In the second phase of its export growth, China eliminated many of these barriers, not so much because of an internally generated process of reform (as occurred during the first phase of growth), but because doing so was a requisite part of China's entry into the World Trade Organization in 2001.

2.2 China's Entry into the WTO: Export Diversification and Acceleration (2001-2010)

China's WTO accession agreement required the country to remove barriers on exports, imports, and foreign investment, and provided it, in turn, with Most-Favored-Nation access to the markets of WTO members.[1] These policy changes helped accelerate China's export growth.

[1] Pierce and Schott (2016) and Handley and Limao (2017) argue that the material impact of China's WTO entry on barriers to its exports was not the actual change in tariffs on Chinese goods among WTO members

Reductions in import tariffs in China gave firms in the country lower cost access to imported inputs and subjected them to greater import competition, leading to higher domestic productivity and lower markups of price over marginal cost. Total factor productivity rose by more in firms facing larger reductions in both input and output tariffs (Brandt et al., 2017). Because imported inputs embody foreign technology, reducing their relative prices unleashes cost-saving and quality-enhancing innovations on the part of firms (Amiti and Konings, 2007; Goldberg et al., 2010). Consistent with this logic, tariff changes in China reduced dispersion in price-cost markups across firms, indicating that trade reform reduced the misallocation of resources within industries (Lu and Yu, 2015). Also contributing to productivity growth was the removal of export restrictions on Chinese firms. China eliminated provisions that required private firms under a specified size to channel exports through state-owned intermediaries. Owing to the inefficiencies of these intermediaries, the practice imposed a substantial effective tax on exporting (Bai et al., 2017). Across all manufacturing industries, the period of trade reform was when China experienced its most rapid TFP growth: average TFP growth was 2.0% per year over 1998 to 2007 and 1.1% per year over 2007 to 2013 (Brandt et al., 2020).

During the second phase of China's export boom, export processing plants accounted for most foreign shipments in manufacturing. In 2005, export processing was responsible for 55% of China's total manufacturing exports (Liu and Ma, 2020). Because of the high import content of these firms' material purchases, the domestic content of China's manufacturing exports was below 65 percent during the 1990s and early 2000s (Koopman et al., 2012; Kee and Tang, 2016). China's later export diversification contributed to a declining importance of export processing, with its share of China's manufacturing exports falling to 35% in 2015, a shift accompanied by an increase in the domestic content of China's foreign shipments.

China's entry into the WTO allowed it to benefit from the dismantling of the Multi-Fiber Arrangement, which had permitted high-income countries to set quotas on apparel and textile

but in uncertainty over future values of these tariffs, especially in the U.S. Although the U.S. had granted China MFN status in 1980, between 1989 and 2000 the U.S. Congress was required to reauthorize this status annually. Reauthorizations were frequently the subject of heated political debate, suggesting that their passage was not a foregone conclusion. Using a quantitative trade model to compare outcomes in trade regimes with and without uncertainty over U.S. trade policy, Handley and Limao (2017) estimate that China's exports would be approximately 30% larger without the uncertainty.

imports. The MFA was phased out in stages between 1994 and 2005, meaning that China began to enjoy quota-free access to high-income apparel and textile markets after 2001.[2] In China, the allocation of quota rights to firms, favored inefficient producers, many of which were state-owned enterprises (Khandelwal et al., 2013). The elimination of the MFA quotas thus permitted the entry of new firms, whose higher productivity generated a massive increase in China's apparel and textile exports to the European Union and the United States. The result was a 21% increase in TFP in China's apparel and textile production, most of which was due to firm entry (Brandt et al., 2012).

2.3 End of the Export Boom: Rolling back Reform and the U.S. China Trade War (2010-2024)

Although President Xi Jinping is often credited with engineering the rollback of economic reforms in China, in truth this rollback appears to have begun years earlier, under President Hu Jintao. In 2008, Hu gave (low productivity) state-owned enterprises renewed prominence in industrial planning (Naughton, 2016), a shift strongly reinforced by Xi when he came to power in 2012 (Lardy, 2019). After 2007, entry of private and foreign-owned manufacturing firms fell sharply (Brandt et al., 2020). The end of the productivity-growth miracle and the rollback of pro-market reforms slowed manufacturing growth after 2010. Whereas the differential in annual manufacturing export growth between China and the rest of the world was 8 percentage points over 1991 to 2010, it was -0.4 percentage points over the 2010 to 2018 period (which spans China's export growth up to the beginning of the U.S.-China trade war).

In 2018, the United States and China entered a period of rising trade tensions, which culminated in sharply higher trade barriers on each other's products. In early 2018, the U.S. government announced new tariffs on washing machines, solar panels, and steel, which led China and the European Union to respond with retaliatory actions against U.S. exports. In 2019, the United States imposed a 25% tariff on a wide range of Chinese imports, to which China reacted swiftly with retaliatory tariffs on US exports. In under two years, the

[2] Between 1974 and 2004, international trade in apparel and textiles was governed but by the Multi-Fiber Arrangement (MFA), under which high-income countries were allowed to impose import quotas on these products. For other goods, the GATT expressly forbade quotas as a tool of trade policy. The MFA, which grew out of restraints that the U.S. had placed on Japan in the 1950s, was initially billed as a mechanism for high-income countries to wind down production in goods in which their comparative advantage was weak, and in which, because of their labor intensity, employment was relatively high. Yet, the elimination of the MFA did not begin until 1995, with most quotas not removed until the 2002 and 2005 phase outs.

average U.S. tariff on Chinese goods jumped from 3% to 21%, while the average Chinese tariff on U.S. goods increased from 8% to 22%. The escalation of the trade war ended in 2020, when the United States and China reached an agreement that left most tariffs in place but set goals for Chinese imports of U.S. goods.

There is substantial academic research on the U.S.-China trade war (Fajgelbaum and Khandelwal, 2022). This work shows that U.S. tariffs on Chinese imports have resulted in higher prices for U.S. consumers and lower average real income for U.S. households (Amiti et al., 2019, 2020, 2021; Carter and Steinbach, 2020; Cavallo et al., 2021; Handley et al., 2020; Fajgelbaum et al., 2020). In response to higher U.S. tariffs on China, other countries expanded their exports to the United States (Fajgelbaum et al., 2021). In some industries, China has engineered this trade diversion. It has been able to partially avoid U.S. tariffs by relocating final assembly of products to other countries, especially Vietnam. In other industries, Chinese firms have tried to soften the impact of higher tariffs by moving production into inland China, where wages and land prices are lower. Since 2018, exports from inland provinces in China have doubled, growing at twice the rate of exports in China's coastal provinces (Douglas, 2023). Although China's inland shift in production began before the U.S.-China trade war, U.S. tariffs may have reinforced the trend.

3. Composition of China's Manufacturing Exports

During all three phases of China's export growth, the country has diversified its exports away from labor-intensive goods into more advanced products. Whereas in 2000, China's top two exports were footwear and children's toys, by 2007 its top two exports were cellphones and laptop computers (these products have retained their top positions out to the present). This shift was due to the combination of (1) early increases in productivity in China, which pushed up wages and priced the country out of some very labor-intensive goods, (2) rising educational attainment of the Chinese labor force, which lowered the cost of producing technology-intensive goods, (3) policy interventions, which subsidized sectors deemed important by the Chinese state, and (4) U.S. tariffs on Chinese imports, which induced China to relocate production in labor-intensive goods to other countries, including Vietnam and elsewhere in Southeast Asia.

3.1 China's Initial Specialization in Labor-Intensive Manufacturing

China's initial export growth was concentrated in products that are strongly intensive in the use of labor in production (Hanson, 2017). These goods include: **apparel, bicycles and scooters, footwear, furniture, household fixtures, plastic products, sports equipment, textiles, travel goods, and toys and games**. They are the products through which low-income countries typically enter production for global markets. In their day, Japan, Korea, Singapore, and Taiwan, began their processes of export-led development by first specializing in these goods. China's global collective export market share in labor-intensive goods rose from 6% in 1984 to 23% in 2001, during the first stages of export-led development, jumped to 40% in 2013, after China's accession to the WTO, and then dropped to 32% in 2018, as China began to diversify away from the products (even before the U.S.-China trade war). China's comparative advantage in labor-intensive products actually peaked in the early 1990s. The country enjoyed spectacular export growth in these products, not because its comparative advantage in them was rising, but because China's overall export growth as so high and these goods at the time constituted a large share of the total. Since the early 1990s, the rate of growth of Chinese exports has been faster outside of labor-intensive industries. Their share in China's total merchandise exports rose from 38% in 1984 to 47% in 1993 before declining to 18% in 2013 and then to 14% in 2018.

What caused the end of China's export surge in labor-intensive manufacturing? One factor is the overall deceleration of economic growth in China. The country's post-Deng boom was in part transitional in nature, implying that it would ultimately play itself out (Song et al., 2011). Once trade and other reforms were in place and a substantial share of the labor force had moved from the countryside to cities, growth rates would naturally subside (Brandt and Lim, 2020). Other contributing factors may have included the slowdown and then reversal in the growth of China's labor force (Li et al., 2012) and the rapid increase in college attainment after 2001 (Ma, 2020). These changes appear to have put upward pressure on the relative wages of less-educated workers, thereby eroding China's comparative advantage in apparel, footwear, and similar products. Changes in state policy may have also mattered for the shift. In 2008, President Hu gave (low productivity) state-owned enterprises (SOEs) stronger support via industrial policies (Naughton, 2016), a shift that President Xi later expanded (Lardy, 2019). The reprioritization of SOEs in China's economy has created a drag on productivity growth (Hsieh and Song, 2015; Brandt et al., 2020), possibly hastening the expiration of China's reform-era productivity-growth miracle.

Which countries have gained most export market share in labor-intensive products in the wake of China's slower growth in the sector? Eight Asian countries —Bangladesh, Cambodia, India, Indonesia, Myanmar, Pakistan, Sri Lanka, and Vietnam—are the largest low-income producers of labor-intensive manufactured goods. Since 2012, three of these—Bangladesh, Cambodia, and Vietnam—have seen the most rapid growth in labor-intensive exports. India and Pakistan are also major players in the sector, owing to their large economic size and low wages, but their growth thus far has been far lower than in Bangladesh and Vietnam. Myanmar and Sri Lanka, for their part, still remain small players in global markets. Among middle-income countries, the largest exports of labor-intensive products are Bulgaria, Romania, and Poland, in Eastern Europe, and Morocco, Tunisia, and Turkey in North Africa and the Middle East.

The growth of Vietnam's manufacturing exports is notable because, similar to China's early growth, much of its export production is in export processing plants that are owned by or contract with multinational enterprises, including many from China. China is now "exporting" to Vietnam the export processing model that it followed in its first phase of export growth. The common practice of export processing is one reason why U.S. tariffs on Chinese imports have not led to expanded employment in U.S. manufacturing (Autor et al., 2024). By producing inputs in China and having Vietnamese firms assemble these inputs into final outputs, China is able to evade U.S. tariffs while still exporting substantial embodied manufacturing content to the U.S. market. (Early evidence of increased Chinese investment in Mexican manufacturing suggests that China may be expanding its use export processing to avoid U.S. tariff barriers.)

3.2 China's Diversification in Sophisticated Manufactured Goods

Today, China has a diversified export base in manufacturing. It is the world's largest exporter of cellphones, laptop computers, and other electronics and these products constitute its largest export categories. Considerable attention has been devoted to the role of China's industrial policy in redirecting the country into advanced manufacturing. A partial list of Chinese policies would include giving firms access to cheap credit via China's state-owned banks, subsidies to firms for the purchase of sophisticated machinery, subsidies to firms for generating patents or achieving other innovation benchmarks, letting firms buy or rent land at discounted prices, inducing foreign firms to transfer technology to Chinese firms, and bans on exports of key raw materials such as rare earths. There is anecdotal and (or) quantitative evidence of the Chinese government engaging in these interventionist policies and that such intervention has increased under President Xi.

At the same time, it is difficult to say how much these policies have affected the structure of Chinese exports and the pace of China's export growth. Understanding the economic impact of industrial policies requires having access to data on Chinese manufacturing firms and to the government policies that affect these firms. Such data on China are available from roughly 1995 to 2016, depending on the industries and policies being considered. However, little data on Chinese firms are available after 2016, presumably due to the government keeping such data out of the public domain. For recent years, we therefore cannot conduct quantitative analysis of productivity growth in Chinese manufacturing, causes of export growth in specific sectors, or how industrial policies have affected Chinese manufacturing industries and exports. We remain in the dark about many recent economic developments in China, especially with regards to advanced manufacturing.

We can say that there are factors besides industrial policy that have contributed to China's recent export growth and its move into advanced manufacturing. One is the rapid educational upgrading of China's labor force. A country's comparative advantage in high-tech products depends heavily on its supply of human capital, which depends in turn on the quality and quantity of a country's institutions of higher education. Between 1999 and 2015, China expanded the number of students enrolled in university by seven times, an increase that is unprecedented. Many have questioned the quality of China's college training, noting high rates of unemployment among recent college graduates (data on which the Chinese government recently began to suppress). It seems plausible that the quality of China's newly expanded university system is uneven. Yet, it is also true that researchers in the best Chinese universities are catching up to researchers in the United States and other countries in the quantity and quality of their academic publications. However many poorly trained college graduates China may be churning out, it appears to be producing enough high-quality students for China to make substantial gains its innovative capacity in many domains.

There is evidence of this impact in data on Chinese manufacturing in the period leading up to 2016 (Ma, 2023). The expanded supply of college grads, which began to be felt in China's labor market in 2004 and later years, led to an increased pace of innovation in Chinese firms specialized in exporting electronics and other sophisticated manufactured goods. In the 12 years after the boom in China's college graduates (2004 to 2016), the share of manufacturing employment comprised of workers specialized in R&D increased by four times and the ratio of spending on R&D to sales in manufacturing firms doubled. Detailed analysis indicates that it was China's advanced manufacturing exporters that benefited most from the increased availability of workers with university degrees. Over the period 2004 to 2016, the expanded supply of university graduates can account for about three-quarters of the increase in R&D intensity in Chinese manufacturing. These results do not imply that other policies have not mattered for China's progress in advanced manufacturing. But we do see evidence that the skill upgrading of China's labor force has played a large role in its technological progress.

4. Policy Options Facing the United States

What should the United States do, in light of these developments in China? First, we should realize that many of China's recent economic shifts are the result of a natural process of economic development, if one that has played out at a rapid pace in a county of immense size. The country's initial specialization in labor-intensive manufacturing and later move into advanced manufacturing are highly reminiscent of what happened in other East Asian economies during their own phases of export-led development. Like its East Asian neighbors, China's comparative advantage has evolved as it has made large investments in human and physical capital and upgraded the technological sophistication of its companies. When a country changes its mix of factors of production, as occurred through China's massive expansion of its university system and greater openness to foreign investment, its pattern of specialization also changes. In China's case, this has meant graduating from specializing in clothes, shoes, and toys to specializing in mobile phones, computers, solar panels, and electric vehicles. No doubt trade and industrial policies in China and the United States also played an important role in this industrial transition. China's subsidies to advanced manufacturing, combined with U.S. tariffs on Chinese consumer goods, likely accelerated China's move away from labor-intensive manufacturing. For U.S. households, the consequence was higher prices on many consumer goods. Softening the blow was the ability of Bangladesh and Vietnam, among other Asian economies, to expand their exports of labor-intensive products to the United States. If the U.S. government wanted to reduce consumer prices for U.S. households, the most immediate action would be to reduce tariffs on Chinese imports.

Second, the United States should anticipate and accelerate future changes in the global supply of labor-intensive products. China's shift away from labor-intensive manufacturing looks permanent, recent expansions of production of these sectors in interior China notwithstanding. With an eye toward protecting the well-being of U.S. households, there are actions the U.S. government could take that would help secure a steady supply of low-priced consumer goods, beyond ending the U.S.-China trade war. By virtue of their large supplies of less-educated workers, India and Pakistan would appear to have a strong latent comparative advantage in labor-intensive manufacturing. However, a combination of policies in these economies that effectively tax manufacturing and subsidize agriculture have prevented them from realizing this potential. India, despite its vast low-wage labor force, is primarily and exporter of business services produces by workers with a college education, and Pakistan, which also has a large low-wage labor force, remains a bit player in global supply chains. The United States could hasten India's and Pakistan's rise as producers of consumer goods via a multilateral trade agreement that negotiated a move away from highly distortionary policies in these economies. That negotiations under the auspices of the World Trade Organization have been moribund for the last three decades may be one reason why India and Pakistan have not emerged to take China's place as leading producers of labor-intensive products (similar to how China supplanted other East Asian economies in the 1990s). U.S. leadership in global trade policy could help avoid future disruptions in global supply chains.

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OPENING STATEMENT OF FRANÇOIS CHIMITS, ANALYST AT MERICS; RESEARCHER AT CENTRE D'ETUDES PROSPECTIVES ET D'INFORMATIONS INTERNATIONALES (CEPII)

COMMISSIONER GLAS: Thank you. Mr. Chimits.

MR. CHIMITS: Good afternoon, everyone. A real pleasure to be here and to have the opportunity to speak about a topic that, so to speak, is dear to my heart, which is the prioritization by PRC of industrial sectors. And so as I did in the testimony, in the written testimony, I will first briefly consider the evolution of the final objectives and the sectors and targets of those industrial priorities by Beijing, and then scope through the new implementation approach that we have seen Beijing unrolling under Xi Jinping and that is often largely misunderstood, and then focus on the case-in-point of SMEs regarding both that new approach and those new ambition that the PRC has developed over time, before, finally, if I have time, I'll consider a little bit the potential reaction the trade partners can put in place in order to prevent Chinese distortion from spilling over their own market and affect their own interests.

So starting with the objective, here it's tightly related to a broader shift of priority that you'll probably well aware of and that is now well documented regarding the priorities of the CCP and the Party-state away from purely growth metrics and more towards security and resilience. And in terms of industrial policy, that means literally a shift from commercial dimensions and commercial objectives and multiple dimensions that pertains to geopolitical and geostrategic capacity, meaning, in that case, more specifically, self-reliance, reduction of dependency, and securitization of value chain. And the byproduct of that, from a sectoral perspective, is that you have seen a reprioritization or a greater focus on those sectors that have strong strategic externalities from Beijing's perspectives and away from sectors that are more genuine, so to speak, from a geoeconomic perspective. And to give you a few examples, services, entertainment, and potentially real estate in some ways.

Now -- as this has more to do with a rebalancing among preexisting priorities, the policies of today will have a lot of overlap and resonance with past policies by Beijing regarding industrial policy. And this is, typically, I know, something that my colleague on the left will touch upon.

Now, when it comes to the approach, and I think it's a particularly interesting point to make, the idea is twofold in that respect. First, under Xi the Party-state has been trying to blend a new—or trying to come up with a new—blend of public forces and market forces for its economy. And this is often portrayed either as a disconnect or lack of consistency in their approach, but I think we have to take CCP leaders at their words. They have the ambition to create a new combination of public intervention and market forces, and that means, in more concrete terms, that the Party-state set the objectives and the incentives under which market forces operate. And here, by market forces, they do not and I do not particularly refer to the absence of the state on the market. From a Beijing perspective, by market forces, we mean decentralized competition by multiple players to gain market shares. Whether those players are state-owned, state-invested, or more purely private from a shareholder perspective is secondary to those discussions.

On top of this new blend, there is more specifically to techno-industrial objective an ambition to develop to what Beijing calls a new whole-of-society approach where basically any stakeholders in the economy is supposed, to say the least, if not guided towards internalizing the priorities of the Party-state in their own behavior. And that looks a bit abstract maybe, so I might refer to one of the exhibits in the written testimony where I give illustration and examples of how that operates. But, typically, that's a good transition to the question of SMEs because SMEs -- the new role of SMEs in Chinese industrial policy is a case-in-point for both the new approach and the new objectives. And so related to the new approach, that means typically that the local courts, the local banks, even the local SOEs or the local private firms and also the local university are asked to particularly target and have preferential treatments towards those certified SMEs that little giant are one breed of. And this renewed emphasis on -- this new emphasis on SMEs and Chinese industrial policies also comes with a more complicated system of certification of SMEs at every level of government, that you have to think of as a kind of a sports league system where the lowest level of government certified a certain level of SMEs that correspond to the priorities from a sectoral perspective but also from dependency reduction, self-reliance perspective, as set by Beijing, and where all the local players will come in to support and to provide specific preferential treatment to those certified corporates.

Maybe to wrap-up, I only have 40 seconds now. This creates particular difficulties in the way we treat those distortions because, traditionally, we have treated those distortions in a framework when we supposedly have the state on the one side and the market and the commercial players on the other. In the case of China, you have a greater entanglement of those two spheres that make any tracking of subsidy or financial transfer from the public sphere to the private commercial sphere harder to track and less reflective of the reality of the support. Hopefully, research institutions and some partners have already paved the way of how to respond to that. That will be for the Q&A, I guess, then.

PREPARED STATEMENT OF FRANÇOIS CHIMITS, ANALYST AT MERICS; RESEARCHER AT CENTRE D'ETUDES PROSPECTIVES ET D'INFORMATIONS INTERNATIONALES (CEPII)

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

Hearing on "Consumer Products from China: Safety, Regulations, and Supply Chains"

March 1, 2024

Testimony by Francois Chimits, Analyst at MERICS and research associate at CEPII

The People's Republic of China (PRC) has been propelled in less than half a century from the backbenches of industrial development to an industrial giant. Measured as a share of global industrial value-added, no other country has concentrated so much global industrial production over the past fifty years, with China amassing more than one third of the world's gross industrial production. After establishing itself as the world's factory in the 1990s, specializing in low value-added products and tasks, such as textiles and processing, the PRC has since the late 2000s incrementally unrolled a dynamic stream of proactive industrial policies. Under President Xi Jinping, this renewed emphasis on techno-industrial ambitions and efforts has only been amplified, while being redirected in terms of objectives and refined in its implementation.

This testimony will try to decipher the China's current approach to industrial policy, encompassing its objectives, priorities, and implementation. As a case in point of this updated techno-industrial philosophy and its limitations, this analysis will focus on the new role of small- and medium-sized enterprises (SMEs) in Beijing's approach. Finally, the testimony will touch upon the difficulties of current mechanisms in preventing cross-border spillovers of Chinese government support to its producers.

I. Chinese industrial priorities, philosophy of intervention and actual policies

a. An opaque mixture of techno-industrial priorities geared toward securitizing the economy

Chinese industrial policies have been redirected over the past decade away from development objectives toward geopolitical and national security priorities. This resonates with the broader deprioritization of growth over security in high-level documents and speeches of the party-state, which is now well documented.[1] In industrial policy, this has translated into a partial shift away from commercial performance and toward self-reliance.

Indigenous innovation (自主创新) has been a core tenet of the nation's development strategy since the National Medium and Long-Term Plan for the Development of Science and Technology (MLP) of 2006. Some more specific national documents have had more forceful foreign technology and supply substitution objectives,[2] which can also be found in the Made in China 2025 initiative to secure China's position as a global tech leader (see

[1] Howard Wang. "'Security Is a Prerequisite for Development': Consensus-Building toward a New Top Priority in the Chinese Communist Party," *Journal of Contemporary China*, August 7, 2022, 1–15.

[2] MIIT, "14th Five-Year Plan for Medical Equipment 十部门关于印发《'十四五'医疗装备产业发展规划》的通知," December 28, 2021, https://www.gov.cn/zhengce/zhengceku/2021-12/28/content_5664991.htm.

below). Obviously, local governments have also from time to time displayed similar ambitions. However, it was only in 2020 that the concept of science and technology self-sufficiency and self-empowerment (科 技 自 立 自 强) was officially proposed and incorporated into the 14th five-year plan (FYP).[3]

In recent years, China has multiplied the sectoral priorities of its industrial policies under various programs and stakeholders.[4] The revival of industrial policy in China is often tracked back to 2006 with the MLP, under the Ministry of Science and Technology (MoST). It was around that period that the more regulatory approach undertaken under former premier Zhu Rongji started to erode more visibly. The 2006 plan targeted a few sectors – shipbuilding, nuclear, aircraft, integrated circuits – and a handful of large national projects that received massive funding after Beijing alleviated the budget constraint on local governments as part of the post-2008 stimulus package.[5]

Since then, the industrial priorities of Beijing have evolved in a flurry of lists, stakeholders, and projects. The strategic emerging industries (SEI) plan of 2010 already listed twenty sectors, placed under the powerful *de facto* economic ministry of the PRC, the National Development and Reform Commission (NDRC).[6] The "innovation-driven development strategy" formalized in 2016 sparked a new round of extending Chinese industrial ambitions to new sectors. The flagship policy of that period was the State Council's Made in China 2025 plan,[7] which listed 10 key priority sectors.[8] The Notice of the State Council on the Publication of Made in China 2025 that followed set a 2020 target of 40 percent internally produced "core basic components and key basic materials" for those sectors, to be raised to 70 percent by 2025.

Other renowned industrial plans also emerged to operationalize the new development strategy, such as Internet Plus, aimed at fostering the digitalization of multiple sectors, or the very broad Military-Civil Fusion (MCF) strategy, designed to support development and integration of civilian technology players with the more traditional defense industry. Sector-specific policies were also published for numerous sectors (photovoltaic, shipbuilding, cloud computing, robotics, medical devices, etc.), some predating and/or overlapping with the previously mentioned broader efforts. In 2020, the NDRC published

[3] Sun Mingzeng (孙明增). "S&T self-sufficiency and self-empowerment (科技自立自 强)," Guangming Daily (光明日报), 9 November 2020.

[4] Naughton, Xiao and Xu. "The Trajectory of China's Industrial Policies." IGCC. 2023. ucigcc.org/wp-content/uploads/2023/06/Naugton-et-al-working-paper-1-jun-2023.pdf

[5] Naughton B. (2021). "The rise of China's industrial policy, 1978 to 2020." Buena Onda, S.A. de C.V. Mexico: Universidad Nacional Autónoma de México.

[6] State Council. "Decision of the State Council on Accelerating the Cultivation and Development of Strategic New Industries 国务院关于加快培育和发展 战略性新兴产业的决定." October 2010. http://www.gov.cn/zwgk/2010-10/18/content_1724848.htm.

[7] J. Wübbeke, M. Meissner, M. J. Zenglein, J. Ives, B. Conrad. "Made in China 2025: the making of high-tech superpower and consequences for industrial countries." MERICS. December 2016.

[8] New generation information technology; Advanced numerical control machine tools and robotics; Aerospace technology, including aircraft engines and airborne equipment; Biopharmaceuticals; High-performance medical equipment; Electrical equipment; Farming machines; Railway equipment; Energy-saving and new energy vehicles; Ocean engineering.

a list for new growth points, referring to new energy technology bottlenecks in a completely different set of sectors.[9]

The PRC also has technological priorities.[10] The concept of "key core technologies (关键核心技术)," which has been around for almost a decade, does not clearly appear to consistently list specific priorities. In 2021, Xi Jinping called for breakthroughs in core technologies related to "urgent national and long-term needs," providing a list of such technologies. This list differed from another one he produced a year later for the "basic core areas related to overall development and national security."[11] In August 2022, the MoST and the Ministry of Finance also promised a list of technologies to focus on.[12] References to "bottleneck technology" have also flourished without one clear list of associated technologies.[13]

Other less authoritative technology lists and concepts are also often referred to in official documents and speeches, sometimes with clearly defined sectors such as "disruptive technologies" established by the Chinese Academic of Engineering.[14] In addition, local government, especially at the provincial level, has drawn its own technology lists, sometimes reusing concepts of the central state and not necessarily with a consistent scope.[15]

b. An ambition to "guide" market forces to achieve party-state priorities

An old Chinese Communist Party (CCP) concept has been revived to signal the ambition for greater market forces under greater guidance of the party-state. This ambition of a new combination of public authorities and market forces under Xi Jinping appeared in key policy documents as early as 2013. The "decisive role of market forces" in resource allocation in the Chinese economy first appeared then in a high-level document that also

[9] The document lists: wind, solar, and water storage, advanced fuel cells, efficient energy storage, and marine energy generation, and construct infrastructure networks such as smart power grids, microgrids, distributed energy resources, new types of energy storage, hydrogen production and hydrogenation facilities, and fuel cell systems. NDRC. *New Chinese Ambitions for 'Strategic Emerging Industries,' Translated* (关于扩大战略性新兴产业投资 培育壮大新增长点增长极的指导意见). September 2020.

[10] In this testimony, we stick to the technologies lists and leave aside the actual industrial supports provided directly to technology research and development, to focus on the core industrial policy. Some excellent reports delve into this very specific environment. J. Groenewegen-Lau and M. Laha. "Controlling the Innovation Chain. China's Strategy to Become a Science & Technology Superpower." MERICS. 2023. https://merics.org/en/report/controlling-innovation-chain.

[11] The former included: oil and gas, basic raw materials, high-end chips, industrial software, agricultural seeds instruments and equipment for scientific experiments, and chemical preparations. The latter: artificial intelligence, quantum information, integrated circuits, advanced manufacturing, life and health, brain science, biological breeding, aerospace technology, and underground and deep-sea exploration.

[12] "Action Plan for Improving Enterprises' Technological Innovation Capability (2022–2023)" (企业技术创新能力提升行动 方案 2022—2023 年））

[13] NMSAC, "Industrial Base Innovation Development Catalogue (2021 Edition) 产业基础创新发展目录（2021 年版）," 2022, http://www.cm2025.org/uploadfile/2022/0805/20220805013919818.pdf.

[14] The list, that aims at "seizing the strategic high ground", is made of: Quantum Information Technology; Artificial Intelligence; Mobile Internet Technology; Gene Editing Technology; Synthetic Biology Technology; Graphene; Metamaterials.

[15] See Table 5 in Naughton, Xiao and Xu, "The Trajectory of China's Industrial Policies," IGCC, July 2023. ucigcc.org/wp-content/uploads/2023/06/Naugton-et-al-working-paper-1-jun-2023.pdf

underlined the necessity of "encouraging, supporting and guiding the non-public sector."[16] If the change in wording sparked expectations of a breakthrough in liberal economic reforms across the board, that proved wrong, multiple localized pro-market measures have been implemented. It is worth noting that less publicized, this language is still present in policy documents.[17] In December 2023, the official press agency of the PRC even claimed that Xi Jinping himself had been behind the decision in 2013 to use the wording "decisive role of market forces". All the while, the term "guidance" has become more and more common in public policy documents. It has long been in the Chinese Communist vocabulary, meaning something closer to sustained leadership rather than only influence.

High-level documents have underlined the ambitioned new interaction between market forces and state interventions. A leading document for the semiconductor sector in 2018 called for the "organic combination of national strategy and the market mechanism."[18] A similar combination can also be found in a 2020 high-level document calling for further marketization to "move industrial policy toward generalized systems of preferences and functional approaches; strengthen support for technological innovation and structural upgrading; and strengthen the coordination between industrial policy and competition policy."[19]

Reforms under Xi Jinping have also refined instruments to incentivize economic entities to align with party-state guidance. Indeed, the previous approach to industrial policy would indicate a priority and allow local governments and state-related players to invest in multiple firms to pursue that ambition, before further down the road consolidating the domestic market around a few "winners". This "picking the winner" approach had encountered mixed results.[20] Significant progresses in industrial and technological capacities have been achieved for instance in high-speed rail, shipbuilding, and satellite technology, but other strategic industries – including most notably semiconductor and aerospace industries – have seen more limited improvements. Even where success can be considered, there is uncertainty regarding the cost incurred to get there. The massive debt of Chinese rolling-stock or ship producers, state-owned, are legitimate reasons to question the optimality of such an approach.

The Communist Party's capacity for influence has been deliberately strengthened to ensure that "the Party rules everything" (as added to the constitution of the PRC in 2017). Anti-corruption campaigns have hit many – from local political operatives to state-owned enterprise (SOE) managers, financial leaders and entrepreneurial figures. And the re-emphasis of the party's absolute control over the whole of society ought to deter entities

[16] The 10th FYP (2001-2005) noted that „market mechanisms are playing increasingly markedly a basic role in the distribution of resources." The 11th FYP (2006-2010) said that China was "giving more play to fundamental role of the market in allocating resources under guidance of macro regulation and control." The 12th gave "full play to the socialist mechanism as well as to the market in terms of allocating resources."

[17] NDRC. "On expanding investment in strategic emerging industries Guiding opinions on cultivating and expanding new growth points 关于扩大战略性新兴产业投资 培育壮大新增长点增长极的指导意见." September 2020.

[18] Ministry of Finance (Economic Construction Division). 2018. "The operation and investments of the National Integrated Circuit Industry Fund are running smoothly" accessed at http://jjs.mof.gov.cn/zhengwuxinxi/gongzuodongtai/201508/ t20150828_1438798.html.

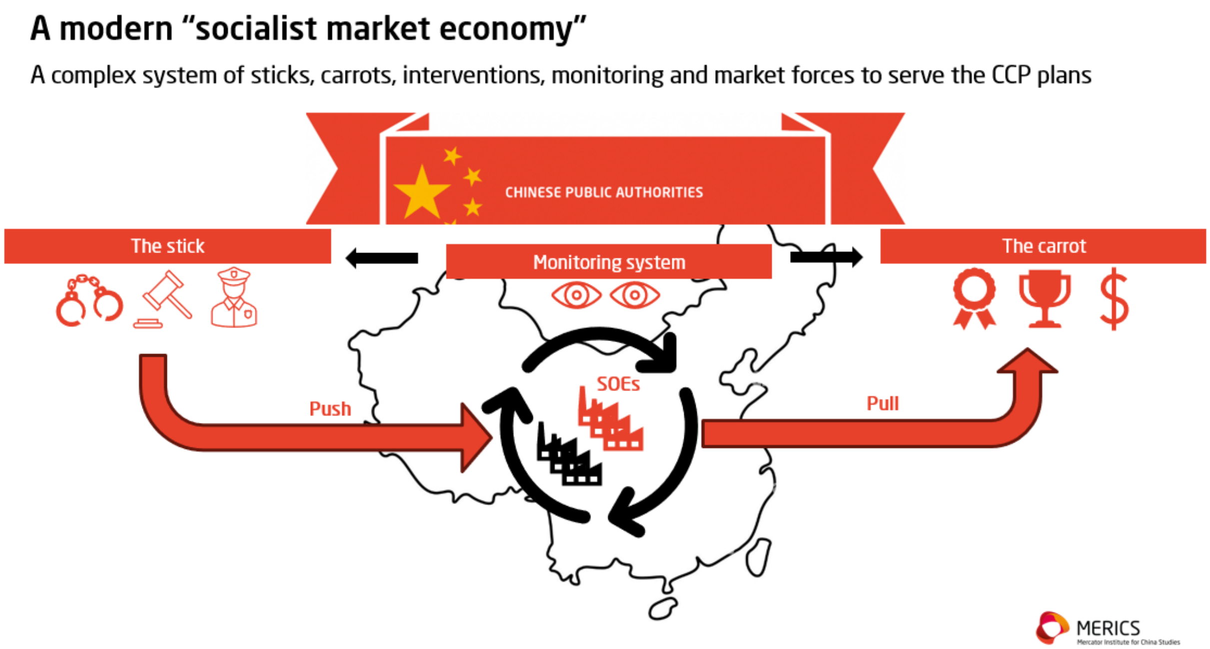
[19] CCP Party Center and State Council. "Views on Accelerating the Perfection of the Socialist Market Economic System in the New Era." New China News Agency. May 2020.

[20] B. Naughton and B. Boland. "CCP Inc.: The Reshaping of China's State Capitalist System." January 2023.

and individuals from being at odds with CCP guidance. The renewed "whole of society" efforts in the pursuit of strategic objectives that encompass techno-industrial priorities, formalizes the idea that all actors of society can be expected to pursue the objectives set by the party-state.[21] Communist Party cells in firms and associations, mandatory for any institution with more than two party members, have been reactivated to help align them with Beijing's goals, even though there role in practice is unclear.[22]

Public investment in firms has bounced back very actively over the past decade. In addition to the newly created golden shares, SOE investment in the economy has picked up, both in absolute and relative numbers.[23] State ownership has also been propelled by a rather novel central instrument in Beijing's industrial ambition: Government Guidance Funds (GGFs, 政 政府引导基金). Not entirely new, these funds really kicked off after 2014, rising to almost USD 2,000 billion of announced investment by 2022 (for more details on those funds see in the dedicated section in 2.c.).[24]

Exhibit 1



[21] J. Gunter, M. Zenglein. "The party knows best: Aligning economic actors with China's strategic goals." MERICS. 2023

[22] Lin, Lauren Yu-Hsin and Curtis J Milhaupt. "Party building or noisy signaling? The contours of political conformity in Chinese corporate governance." The Journal of Legal Studies, 50, 187–217. 2021. For a more up-to-date and comprehensive version of this work, refer to their presentation at the event "How private are Chinese companies?" organized by the CSIS in February 2023.

[23] Allen Franklin, Junhui Cai, Xian Gu, Jun "QJ" Qian, Linda Zhao and Wu Zhu (2022). "Centralization or Decentralization? The Evolution of State-Ownership in China." SSRN Working Paper 4283197.

[24] Wei Y., Ang Y. and Jia N. (2022). "The Promise and Pitfalls of Government Guidance Funds." The China Quarterly.

c. The central role of financial markets

The government is developing a new blend of state capitalism to guide financing toward party-state priorities. On the one hand, it is reducing distortions that benefit traditionally favored sectors and actors, and, on the other, it is creating new distortions that benefit new favored peers. While the former may have had a pro-market aspect, the latter are like a form of modernized statism – where the state has considerable control over the economy and society.

Reducing distortions mostly means fighting the deeply entrenched bias in favor of state-connected and large firms in the allocation of financial resources in China.[25] This bias is rooted in China's bank-centered financial system and pervasive implicit state-guarantees (i.e. the perception that the party-state will always bail out large and connected firms). China's long limited legal framework, high opacity, pervasive political interventions, and constrained risk-pricing have incentivized banks and investors to lend to state-connected and large firms.[26] On top of those genuine factors, the political economy in China, where local governments are strongly aligned with the interests of local business and financial leaders, also contributes to the bias.[27]

Since 2017, China has introduced reforms to make the financial system more market driven by trying to alleviate some of these factors of distortion. The most important reform was greater tolerance for default and insolvency, thus reducing the implicit guarantee, translating into the financially healthy appearance of default (see exhibit 2).[28] Such defaults have hit SOEs, banks and large conglomerates, which were the biggest beneficiaries of the implicit state guarantee. The liberalization of interest rates on deposits and loans, officially achieved in 2015 was further advanced in 2019 with a more market-based "indicative" benchmark, the Loan Prime Rate.

Another substantial dimension of that more liberal-leaning effort has been the reform of direct financing channels, mainly bonds and stock exchanges. However, the ultimate goal is clear, as stated by the then-chairman of the securities regulator, Yi Huiman: capital markets exist to "help implement national strategies regarding technological self-reliance and the development of modern industries."[29] A registration-based procedure for approving initial public offerings (IPO) has been tested and implemented across the board

[25] Zhe Geng, Jun Pan. "The SOE Premium and Government Support in China's Credit Market." NBER. December 2019. A. Harisson et al. "Can a Tiger Change Its Stripes? Reform of Chinese State-Owned Enterprises in the Penumbra of the State." NBER. January 2019. Diego Cerdeiro and Ciane Ruane. "China's Declining Business Dynamism." IMF. Working Paper No. 2022/032. 2022.

[26] "Policies however continue to guide deposit rate pricing. After the deposit rate ceiling was phased out in 2015, authorities introduced a self-regulatory mechanism for deposit pricing" (IMF. "People's Republic of China: Selected Issues." Staff Country Reports, 2020, 15 January 2021.) The selected issues of the equivalent report for 2022 underlines a tightening of the constrain over the past few years, alongside one of the quota mechanism, under the Chinese Macroprudential mechanism established in 2016 and deepened since then (IMF. "People's Republic of China: Selected Issues." IMF Staff Country Reports, 2022. February 2023).

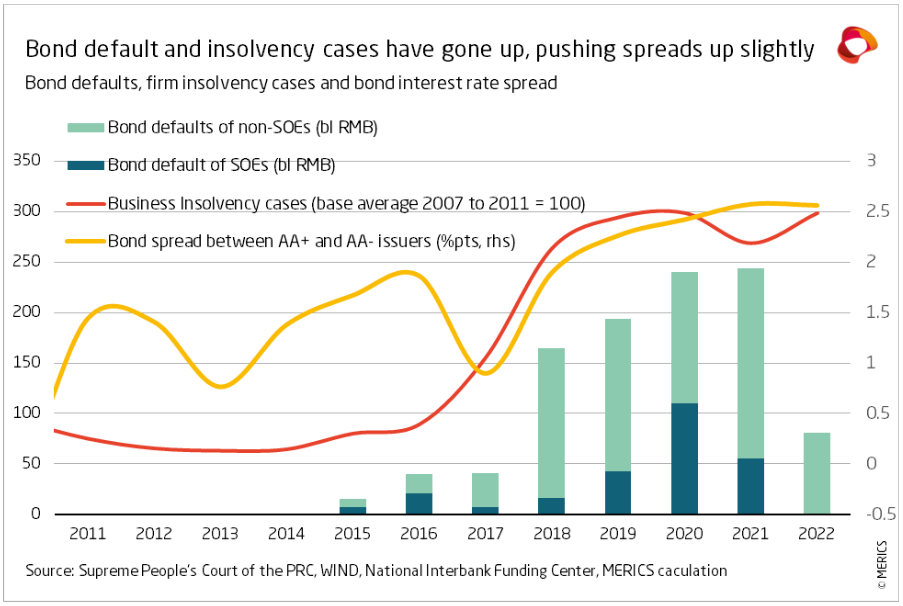
[27] Yu, J., L.-A. Zhou, and G. Zhu. "Strategic interaction in political competition: Evidence from spatial effects across Chinese cities." Regional Science and Urban Economics, 57, 23–37. C. Xu. "The fundamental institutions of China's reforms and development." Journal of Economic Literature, 49, 1076–1151. 2021. Jia, R., M. Kudamatsu, and D. Seim. "Political selection in China: The complementary roles of connections and performance." Journal of the European Economic Association. 13, 631–668. 2015.

[28] Bo Li and J. Ponticelli. "Going Bankrupt in China." *Review Of Finance* 26, no. 3. May 2022.

[29] Huiman Yi. "Further Improve the Functions of the Capital Market (Reflections) 进一步健全资本市场功能（感言)." People's Daily. December 2022.

over three years. In addition, the government has expanded listing opportunities for high-tech SMEs on the mainland stock markets. In 2019, China set up the Shanghai Stock Exchange Science and Technology Innovation Board, also known as the STAR market. The new Beijing Stock Exchange (BSE) was created in 2021 to fulfill this need. Policymakers have progressively liberalized the STAR Market and ChiNext stock market, both dedicated financial exchanges for SME and tech-intensive firms.

Exhibit 2



However, those reforms have not exactly worked. The lack of volatility in the deposit rate among thousands of banking institutions after formal liberalization reflects that some form of strong control remains in place.[30] Other government priorities, including the 2017-2018 deleveraging and regulatory tightening campaign, have further restrained capital flows to riskier firms, such as smaller and non-state-backed ones.[31]

More directive measures have had greater success in guiding capital to prioritized sectors and firms. The central bank has developed new directive instruments to lower the cost of loans in line with certain policy priorities.[32] The People's Bank of China (PBoC) has also included similar criteria in its macroprudential assessment of Chinese financial institutions.[33] Its monetary policy reports prominently feature efforts to "guide" new

[30] The IMF underlined a tightening of the constrain over the past few years, alongside one of the quota mechanisms, under the Chinese macroprudential assessment established in 2016 and deepened since then (IMF. "People's Republic of China: Selected Issues." Staff Country Reports, 2022 2023).

[31] Allen, F and X Gu (2020). "Shadow banking in China compared to other countries." Manchester School, vol 89 (5). September 2020. Wang, Hao and Wang, Honglin and Wang, Lisheng and Zhou, Hao. "Shadow Banking: China's Dual-Track Interest Rate Liberalization." American Economic Association. October 2019.

[32] IMF. "People's Republic of China: Selected Issues." IMF Staff Country Reports. *2022*.

[33] ibid

loans as well.[34] The fact that the central bank also operates "window guidance" – informal and opaque recommendations to financial institutions in their allocation decision – gives an indication of how forceful such "guidance" can be in practice.[35] Indeed, multiple banks have vocally publicized the massive amount of loans they are channeling to such priorities.[36]

A key aspect of China's new blend of state capitalism is the certification effect (i.e., the impact of the government's stamp of approval). Earning the "Specialized SME" or "Little Giant" label essentially certifies that an SME is perceived by the public authorities as a leader among their peers with significant growth and innovation potential, as well as given preferential access to government support. This sort of government imprimatur can work as a form of last-mile guidance for investments, complementing the sectoral priorities established by the party-state. In the words of a Beijing-based joint stock bank credit manager, no matter whether the Specialized SME is certified by the central or local government, banks will approve their loans quickly and without collateral.[37]

Box: What exactly can we know of Chinese industrial subsidies?[38]

While Chinese industrial subsidies have been one of the key drivers of international trade tensions, their details are often overlooked.[39]

If empirical data is an issue for the entire field of industrial policy studies, when it comes to China, the problem is particularly acute.[40] The delegation of public policy to local authorities (more than 4,000 administrative entities) – something unmatched in the world in terms of share of public spending – makes national aggregates hard to compile. The absence of clear boundaries and responsibilities for the public sector adds an extra layer of difficulty. The role and characterization of companies with the state as their main shareholder is often unclear, with local government financing vehicles in particular obscuring the limits on public authorities. The complicated history of private ownership in

[34] China Monetary Policy Report Q4 2021 (PBOC, 2022), China Monetary Policy Report Q2 2019 (PBOC, 2019), China Monetary Policy Report Q4 2018 (PBOC, 2019).

[35] Simon Dikau & Ulrich Volz (2023) Out of the window? Green monetary policy in China: window guidance and the promotion of sustainable lending and investment, Climate Policy, 23:1, 122-137

[36] Sina. "China Development Bank Has Issued 13.1 Billion Yuan in Loans in the First Three Quarters to Support Specialized and New SMEs 国家开发银行前三季度已发放 131 亿元贷款支持专精特新中小企业," October 2022. l. Sina, "Jiangxi Bank's 'Specialized Special New Loan' Injects Financial 'Living Water' into the Development of SMEs 江西银行'专精特新贷'为中小企业发展注入金融'活水'." September 2022. Sina, "Specialized Special New Enterprise Financing Credit May Be More Flexible 专精特新企业融资授信或将更加灵活." May 2022.

[37] Jiaying Xiang. "'Professional and Special New Loans Have Become a Compulsory Course for Banks'——New Trends in Loan Issuance from the Perspective of a Credit Manager '投放专精特新已成银行必修课'——一位信贷经理视角下的贷款投放新动向," Sina. December 2022.; Real interest rate based on calculation in Chapter 4.

[38] This box is a summary of: F. Chimits. "What Do We Know About Chinese Industrial Subsidies?" Policy Brief n42. CEPII. 2023.

[39] There is no consensus on the definition of an industrial subsidy, whether legal or conceptual. To avoid any confusion with the existing national and international legal definition, and to better capture the phenomenon at stake, economists sometimes refer to direct public support for production as all actions by public authorities designed to directly encourage an increase in production, without restricting to direct financial transfer alone. For the sake of fluidity, in this box the term subsidy will be used to refer to that definition.

[40] Lane N. "The New Empirics of Industrial Policy." Journal of Industry, Competition & Trade. Springer, 20(2). 2022.

modern China does not help.[41] Finally, the illiberal nature of the Chinese political system does not favor optimal access to and circulation of information.

No official registry exists. Unlike in the EU and the US, the Chinese government does not keep an open registry of its public subsidies to production, nor does it publish a consolidated budget line for subsidies. On the other hand, as a member of the World Trade Organization (WTO), China is obliged to report its subsidies on an annual basis, which are then published. Because of its accession protocol, this obligation for mainland China exceeds those of all WTO members. However, the lack of effective sanctions for infringement of this obligation enabled China to make its first notification in 2006 and its second in 2010. The list of subsidies Beijing provided to the WTO remains patchy to date, despite a marked improvement in recent years.[42] Even when enriched with counter-notifications made by third parties (the US), the list appears largely incomplete (61 non-agricultural subsidies at the national level in 2014, and 200 counter-notified by the USA; to be compared with information from other sources listed below). To make matters worse, these values are not systematically provided, let alone assessed in an objective and standardized manner.

A review of the existing datasets and methodologies used to assess Chinese public support finds that the most frequently used datasets are dated and/or largely incomplete.[43] The existing datasets only offer a partial coverage of situation in China – either missing local government actions, only capturing listed firms or stopping in 2013. Overall, they only inform on a limited part of the PRC's public support for industrial production. The less direct approach of recomputing state-support from abnormal prices of inputs on firms' balance sheets, such as those from the OECD, has found support of a different magnitude than the traditional datasets covering direct and formal subsidies (see graphic).[44] Even there, the scope of distortions covered remains limited. As an illustration, the following channels of support have not, to our knowledge, been assessed despite much anecdotal evidence of intended distortions by Chinese authorities: coercive technology transfers,[45] strategic mobilization of public procurement,[46] purchase subsidies for domestic industries,[47] attracting foreign talent,[48] upstream sectors and export

[41] Rithmire M. and Hao Chen (2021). "The Emergence of Mafialike Business Systems in China." Harvard Business School. Working Paper 21-098.

[42] Gao H. "The WTO Transparency Obligations and China." The Journal of Comparative Law 12:2: 329-55. 2018.

[43] For a more detailed analysis of the values and limitations of those existing datasets, see; F. Chimits (2023). "What Do We Know About Chinese Industrial Subsidies?" Policy Brief n42. CEPII.

[44] OECD. "Government support in industrial sectors: A synthesis report." Trade Policy Papers, no. 270. 2023.

[45] Prud'homme D., von Zedtwitz M., Thraen J.J., Bader M. "'Forced technology transfer' policies: Workings in China and strategic implications." Technological Forecasting and Social Change, vol. 134(C), pp. 150-168. 2018

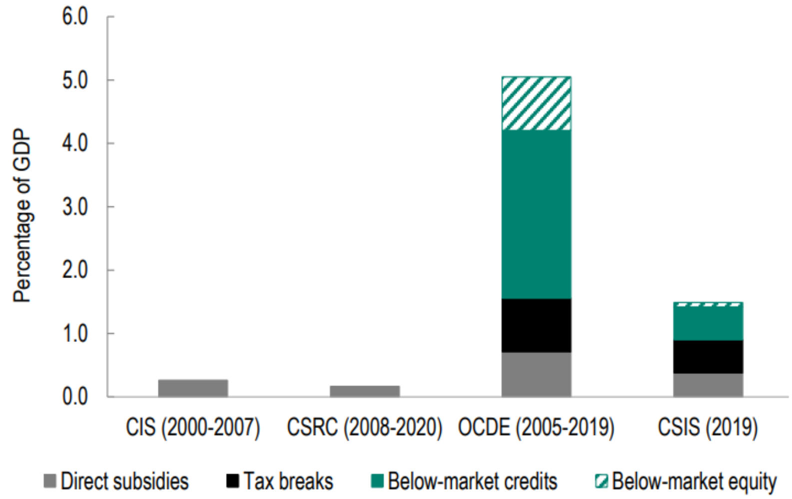
[46] A note of the French administration details these efforts in the software sector (Direction générale du Trésor (2022). "La stratégie de nationalisation des chaînes de valeur industrielles.". Bulletin d'analyse économique Chine du Service Economique de Pékin (French Embassy in Beijing)), which a study finds at work in strategic sectors (Kratz A. and Oertel J. (2021). "Home advantage: How China's protected market threatens Europe's economic power." European Council on Foreign Relations & Rhodium Group). These practices are apparently not confined to industrial objectives (Hanming K., Li M. and Wu Z. (2022). "Tournament-Style Political Competition and Local Protectionism: Theory and Evidence from China." NBER).

[47] In the case of electric vehicles, purchase subsidies were conditional on the use of batteries from a specific list of providers exclusively made by Chinese firms ("China's "whitelist" of power battery companies abolished," Neware, June 2019).

[48] Lu M., Zheng J., Jean A. and Lu Y. (2022). "China's International Talent Policy (ITP): The Changes and Driving Forces 1978- 2020." Journal of Contemporary China, 31:136, 644-661

restrictions,[49] strategic attraction of foreign goods and capital,[50] and preferential treatment in administrative and even judicial procedures.[51]

Exhibit 3: The various channels of Chinese support to industrial production



Note: All series are simple averages of annual data as a share of GDP over the period covered. OECD data has been converted to percentage of GDP by applying the 2005-2019 average ratio of total annual domestic industrial enterprise revenue (from the Chinese National Bureau of Statistics) to GDP.

Sources: NBS, CSRC, OCDE, CSIS.

The Chinese authorities' highly structured and detailed communication and policy planning offers interesting alternative metrics to assess the distribution and evolution of public support to industries. Such an approach complements the more quantitative methodologies above to calculate the actual subsidies to industrial production in China. Some more refined works have developed quantifications of Chinese industrial policy priorities based on language analysis. The language of China's five-year plans has been investigated to identify industries Beijing supports, based on a methodology developed by

[49] Garred J. (2018). "The Persistence of Trade Policy in China After WTO Accession." Journal of International Economics 114: 130-142. Gourdon J., Monjon S. and Poncet S. (2014). "Incomplete VAT rebates to exporters: how do they affect China's export performance." CEPII Working Paper no. 2014-05.

[50] For instance, the Guangdong provincial government circumscribed an effort to attract foreign capital to strategic industrial sectors, including selective market opening and incentives for domestic and foreign financial institutions to finance such projects (Notice of the General Office of the People's Government of Guangdong Province on Printing and Distributing Several Policies and Measures to Promote the High-quality Development of Investment Attraction in Guangdong, March 2023). Other illustrations of such openings based on the needs perceived by Beijing can be found in: OECD (2021). "Report on China's shipbuilding industry and policies affecting it." OECD Science, Technology and Industry Policy Papers, no. 105. OECD Publishing, Paris; OECD (2023). "Measuring distortions in international markets: The rolling-stock value chain.". OECD Trade Policy Papers, no. 267. OECD Publishing, Paris.

[51] The "Notice to support emission obligation of technological and innovative companies" published by the Chinese state participation agency and the financial regulator in November 2022 calls for a priority in the validation process of the issuance of bonds from such firms (中国证监会 国务院国资委关于 支持中央企业发行科技创新公司债券的通知_中国证券监督管理委 员会 (csrc.gov.cn)). A directive from the Ministry of Industry and the Intellectual Property Enforcement Agency recently encouraged the judicial system to deal diligently and severely with IP infringements penalizing firms recognized as strategic (CNIPA and MIIT, "Notice on intellectual property rights measures to help the innovation and development of 'specialized and sophisticated' SME," October 28, 2022).

Chinese researchers.[52] Others have performed a language analysis of some 40,000 official documents to sort industrial policies by various levels of government in China between "most," "mild" and "not" interventionist measures.[53]

II. SMEs, a telling new priority of industrial policies[54]

The Chinese government has been building up a nationwide initiative to identify and cultivate promising "specialized SMEs" in strategic industries and grant them privileged access to public and private resources.[55] In some ways, the government has taken on the role of an incubator to replicate the success of the startup and venture capital scene in software and platform technologies and applied it to hardware technologies where China is reliant on foreign companies. Larger firms still play a central role, but Beijing is now attempting to enhance the contribution of smaller firms as well.

This endeavor embodies and illustrates the new approach Beijing wishes to implement to pursue techno-industrial objectives. Policymakers intend to leverage the dynamism that comes from bottom-up entrepreneurship and competition between SMEs through a top-down framework to achieve national technological goals. In Beijing's eyes, top-down government guidance and market-based competition are not mutually exclusive. They are complementary.

"The birth of a hidden champion is not a one-day effort. It requires a cultivation process with strategic patience … We should further foster and develop hidden champions in advanced manufacturing segments … especially those that can fill technological shortcomings." Dong Jingmei, Economic Forecasting Department at the State Information Center (affiliated with NDRC)[56]

It is interesting to note that this new emphasis on SMEs happened concomitantly with the growing focus on self-reliance (see Exhibit 4). And it goes beyond a simple correlation. As former Vice Premier Liu He underlined: "The soul of 'Specialized SMEs' is innovation. At China's current economic development stage, science and technology innovation is not only a development issue but also a survival issue."[57] Three days after this statement, a readout of the Politburo's discussion headed by Xi Jinping mentioned innovation, resilience, Specialized SMEs and bottleneck technologies in one sentence. Indeed, selection criteria for government-supported SMEs now emphasize the replacement of foreign companies in key technology chains.

[52] Xiao C., Fos V. and Wei J. (2020). "A race to lead: How Chinese government interventions shape U.S.-China production competition." Social Science Research Network Working Paper.

[53] Tan Y. (2021). Disaggregating China, Inc.: State Strategies in the Liberal Economic Order. Cornell University Press.

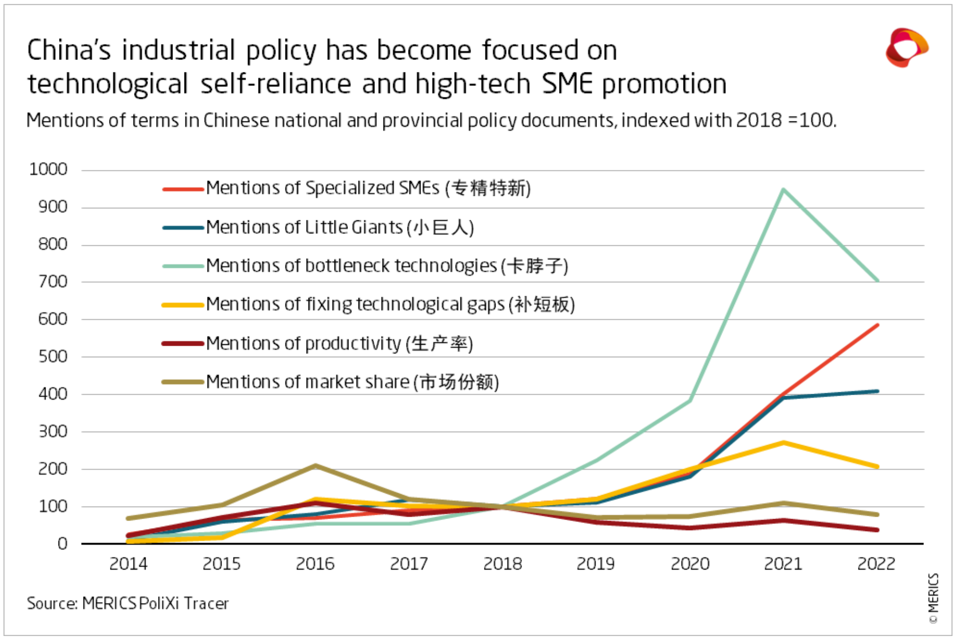
[54] This chapter is derived from a MERICS report the author wrote with colleagues: A. Brown, F. Chimits, G. Sebastian (2023). "Accelerator state: How China fosters `Little Giant` companies." MERICS Report. MERICS.

[55] Chinese SMEs can be quite large. What constitutes an SME in China could very well pass for a small corporation in Europe or North America. According to China's legal classification, SME status differs by industry but generally, SMEs can have as many as 1,000 employees and CNY 400 million in revenue (in sectors like IT or construction numbers can be double). In Europe, in contrast, SMEs employ fewer than 250 persons and have an annual turnover below EUR 50 million (CNY 360 million).

[56] Jingmei Dong. "Expert Opinion】 Invisible Champion Cultivation Path under the Construction of New Development Pattern 【专家观点】新发展格局构建下的隐形冠军培育路径" (NDRC, November 2021).

[57] CNII, "Speech by Liu at the National Summit on 'Specialized and Sophisticated' SMEs 刘鹤在全国'专精特新'中小企业高峰论坛上的致辞," July 27, 2021, https://www.cnii.com.cn/sz/202107/t20210727_296857.html.

Exhibit 4



a. A multi-tier selection process of the hot prospects

Like a sports federation trying to develop an Olympic team, Beijing is rolling out a "pyramid cultivation system" (梯度培育体系) to dynamically select the most promising firms for support (see exhibit 5)**.** The system runs on a good dose of competition in the selection process to ensure that support measures and resources are allocated to the most competitive and promising players. Companies are only guaranteed their spot as government-certified SMEs for three years.

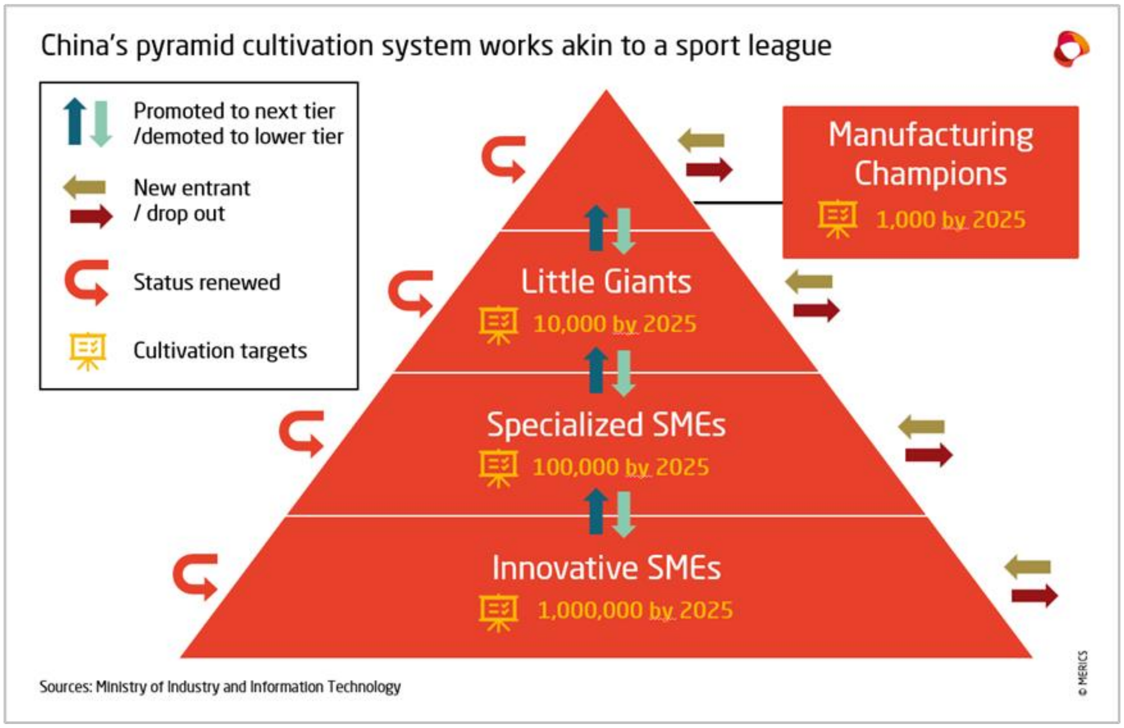
Municipal and provincial governments identify, evaluate, and select local high-tech SMEs based on specific selection criteria. They are then recommended to the central government for further support. Provincial governments draw on this vast pool of innovative SMEs to select more advanced Specialized SMEs (专精特新中小企业) that can tap into a wide array of support mechanisms. The cream of the crop is then promoted to national Little Giant (小巨人) status, and after reaching a certain size, can be recognized as Manufacturing Champions (制造业单项冠军). The last two are considered to be model firms in China's pursuit of innovation-driven development.[58]

Selection criteria have remained rather constant over time, except for the upgrade of technological bottlenecks and substitutes for foreign inputs, and for the corresponding decrease in commercial performance. For each of the programs described in the previous paragraph, the public authority in charge launches a selection process every three years or so, based on updated criteria. No comprehensive analysis of those criteria and their

[58] Pingjun Zhou, "'Specialized, Specialized and New' SME Development Policy Orientation '专精特新'中小企业发展政策取向" (Advanced Manufacturing Technology Business School, 2022).

evolution has been brought to my attention, but reviews of local documents indicate that the usual criteria include growth performance, the number of invention patents, R&D intensity, and niche product focus.[59] Tellingly, for Little Giants, the criteria of the fourth and fifth batches explicitly ask SMEs whether they fill technological bottlenecks or replace products of foreign companies. [60]

Exhibit 5



By July 2023, policymakers had identified more than 70,000 Specialized SMEs (专精特新中小企业) and 12,000 Little Giant SMEs (小巨人), namely high-tech SME firms selected for preferential treatment at the provincial and national level. Officials aim to raise these numbers to over 80,000 and 10,000, respectively, by the end of 2023.[61] Overall, the review process extended the Little Giants status for 155 of the 248 firms selected in the first batch, equivalent to a pass rate of about 60 percent. Out of the 4762 firms selected in the first three rounds of Little Giants, 114 have grown into Manufacturing Champions.[62]

[59] MIIT, "Interim Measures for the Management of Gradient Cultivation of High-Quality Small and Medium-Sized Enterprises 优质中小企业梯度培育管理暂行办法," June 2022.

[60] MIIT, "Interim Measures for the Management of Gradient Cultivation of High-Quality Small and Medium-Sized Enterprises 优质中小企业梯度培育管理暂行办法," June 2022.

[61] MIIT, "National Industry and Information Technology Work Conference Held in Beijing 全国工业和信息化工作会议在京召开," January 11, 2023.

[62] Fang Fang, "The Robot Industry Chain Has Added 72 New National-Level Specialized Special 'Little Giants'机器人产业链又添 72 个国家级专精特新'小巨人'." Gaogong Robot Network. September 2022. People's Daily, "Accelerate the Development of Specialized, Special and New 'Little Giant' Enterprises 专精特新'小巨人'企业发展加速," August 2021.

b. A reform package mixes the alleviation of distortions that help larger firms and new distortions to support SMEs

In the meantime, Chinese public authorities have rolled out new supportive measures targeted at SMEs. The most obvious and direct measures are government subsidies for Specialized SMEs and Little Giants. From 2021 to 2025 the central government will provide at least CNY 10 billion in direct funds to support 10,000 Little Giants. But the size of subsidies differs widely based on where a firm is headquartered. For instance, a nationally recognized Little Giant can receive a one-time award between CNY 500,000 and CNY 6 million which is often matched at the provincial level.[63] Municipal and district-level governments can provide additional funds.[64] The average Little Giant will receive at least CNY 2 million in direct subsidies through the Little Giant program. Wealthy local governments often go above and beyond to support their local high-tech SMEs. Guangzhou is a case in point for a particularly generous local government.[65]

Leaving aside the financial dimension for now (see below), the government is also mobilizing various and unusual state-connected actors and policies to support high-tech SMEs. These include promoting collaboration with universities and research institutes, guiding procurement and R&D funding, and a specifically more robust IP system to support high-tech SMEs.[66] These central policy measures are already trickling down to local governments which are starting to issue their own support measures based on central targets. Nanjing's government intends to cultivate 1,000 Specialized SMEs, 300 Little Giants and 30 Manufacturing Champions by 2025 and has issued a policy to boost SME-university collaboration. Among the many support measures, the local government specifies that Specialized SMEs cooperating with universities will receive priority recommendation for Little Giant titles (see annex for more details).[67]

Large firms, SOEs or not, are also called upon to provide support. In May 2022 the government released a notice signaling that the government expects large corporates,

[63] Guangzhou Municipal Government, "关于印发广州市'专精特新'中小企业培育三年行动方案（2022—2024）的通知," April 26, 2022. KbossChina. "Notice of the General Office of the Ministry of Industry and Information Technology on Carrying out the Fourth Batch of Specialized and New 'Little Giant' Enterprise Cultivation and the First Batch of Specialized and New 'Little Giant' Enterprise Review Work 工业和信息化部办公厅关于开展第四批专精特新'小巨人'企业培育和第一批专精特新'小巨人'企业复核工作的通知," 2022, https://www.kbosschina.com/zizhu/xiaojuren/; 861718.com, "Specialized and Special New Small Giant Enterprise Reward Standard: 6 Million Yuan per Family at the National Level, 2 Million Yuan per Year 专精特新小巨人企业奖励标准：国家级 600 万元/家，每年 200 万." January 2022. Nanfang Daily Online Edition, "广州：新认定国家级专精特新'小巨人'企业免申即享百万奖励 Guangzhou: Newly Recognized National-Level Specialized and New 'Little Giant' Enterprises Can Enjoy Millions of Rewards without Application." April 2022.

[64] Guangdong Province Industrial Park Association, "Summary of 'Specialized, Special and New' National Reward and Subsidy Policies '专精特新'全国奖补政策汇总." 2022. Guangzhou Huangpu District Gov., "Guangzhou Huangpu District Guangzhou Development Zone to Further Support the High-Quality Development of Specialized and Special New Enterprises 广州市黄埔区 广州开发区进一步支持专精特新企业高质量发展办法," 2021.

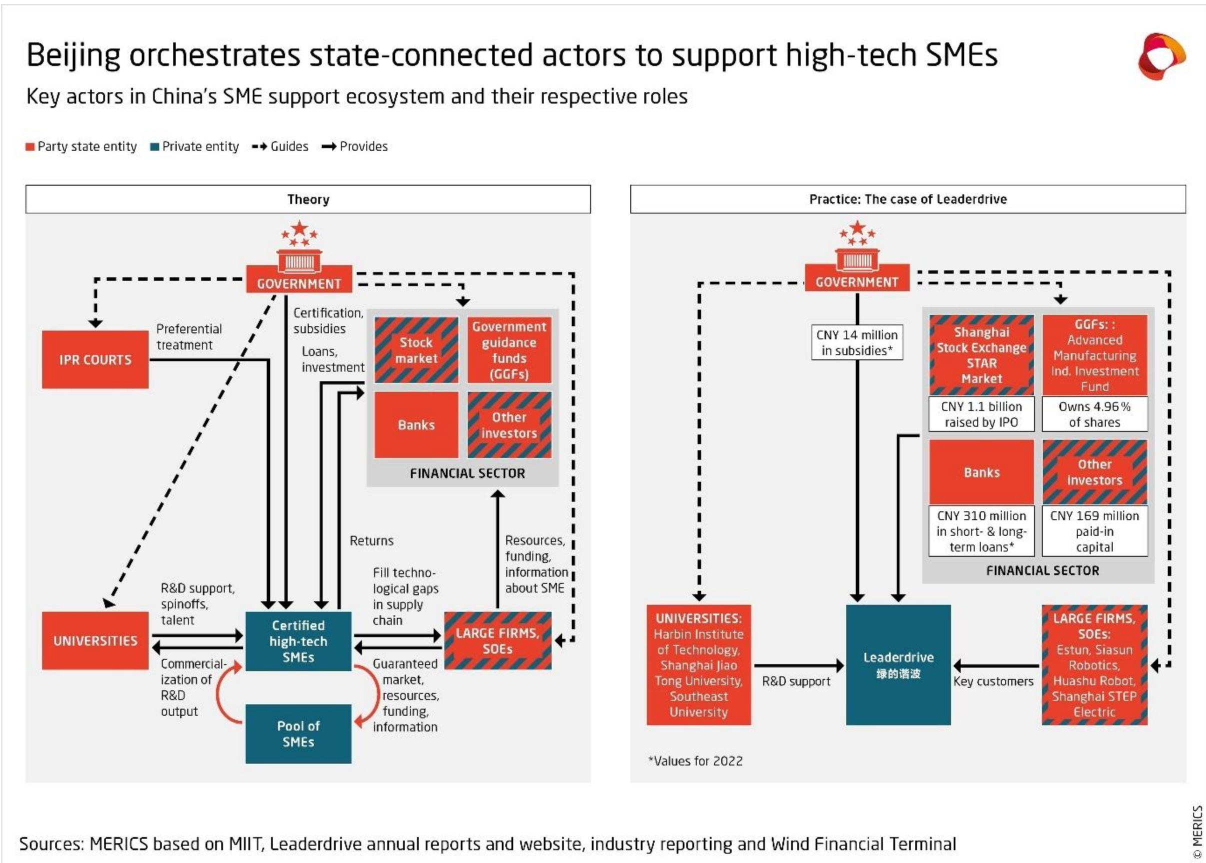
[65] Guangzhou Huangpu District Government, "Guangzhou Huangpu District Guangzhou Development Zone to Further Support the High-Quality Development of Specialized and Special New Enterprises 广州市黄埔区 广州开发区进一步支持专精特新企业高质量发展办法."

[66] For details and references, see A. Brown, F. Chimits, G. Sebastian (2023). "Accelerator state: How China fosters "Little Giant" companies." MERICS Report. MERICS.

[67] Nanjing Municipal Government, "关于印发南京市深化校企协同创新建设培育专精特新企业示范城市若干政策措施的通知," September 2022.

especially SOEs, to play a larger role in supporting innovative SMEs.[68] The MIIT think tank China Academy for Information and Communications Technology (CAICT) has built an online platform to match large firms with SMEs.[69] Meanwhile, the Chinese SOE watchdog, SASAC, not only helped draft the May 2022 government notice[70] which mentions that SOEs will receive additional points in their KPIs for promoting the integration and innovation of Specialized SMEs, but also highlighted the cultivation of Specialized SMEs as a priority for 2023 during meetings with local SASC leaders.[71]

Exhibit 6



[68] MIIT et. al., "Notice on 'Hand in Hand Action' to Promote the Innovative Integration of Large Firms and SMEs (2022-2025)关于开展'携手行动'促进大中小企业融通创新（2022-2025 年）的通知."

[69] MIIT. "Notice on Printing and Distributing the Operation Guide for the 'Hundred Fields and Thousands of Enterprises' Integration and Innovation Matchmaking Activities of Large and Small Enterprises 关于印发'百场万企'大中小企业融通创新对接交流活动操作指南的通知." September 2022.

[70] MIIT et. al., "Notice on 'Hand in Hand Action' to Promote the Innovative Integration of Large Firms and SMEs (2022-2025)关于开展'携手行动'促进大中小企业融通创新（2022-2025 年）的通知."

[71] SASAC, "The State-Owned Assets Supervision and Administration Commission of the State Council Held a Meeting of Local SASAC Leaders to Deepen the Reform of State-Owned Assets and State-Owned Enterprises, Promote High-Quality Development, and Make New Contributions to the Comprehensive Construction of a Modern Socialist Country 国务院国资委召开地方国资委负责人会议深化国资国企改革推进高质量发展为全面建设社会主义现代化国家开好局起好步作出新贡献," January 2023.

c. The ambition of a refined financial system

Most of the instruments and measures mentioned in the section on reforming the financial sector to "guide" resources toward party-state priorities are specifically geared for high-tech SMEs. Official guiding instruments have most often targeted either SMEs or high-tech firms. According to the abovementioned central bank monetary policy report, so does most of the unofficial "window guidance." Similarly, most of the stock exchange reforms have been aimed at facilitating the funding of high-tech SMEs (see Exhibit 7).

In January 2023, the State Council signaled its intention to double-down on such an approach. A set of measures published to support MSMEs, including Specialized SMEs and Little Giants, refers to "making effective use of monetary policy tools (…) to continue to guide financial institutions to increase lending to MSMEs." [72] This is part of a clear ambition to "guide more funds to invest in advanced manufacturing and strategic emerging industries, and better serve key core technology research enterprises and Specialized SMEs," as the governor of the PBOC recently explained.[73]

Exhibit 7: China's main financial exchanges serving high-tech SMEs

Year founded	2009	2019	2021
Location	Shenzhen	Shanghai	Beijing
Minimum estimated market value at IPO	CNY 1 billion	CNY 1 billion	CNY 200 million
Approval procedure	Registration-based since 2020	Registration-based since inception	Registration-based since inception
Market cap*	CNY 12.3 trillion	CNY 6.7 trillion	CNY 226.26 billion
Number of listed firms**	1247	510	184
Number of Little Giants (share of total firms listed)**	247 (20 percent)	220 (43 percent)	73 (40 percent)

* Data valid as of January 27, 2023.
** Data valid as of March 31, 2023.
Source: Exchange websites, Wind financial terminal, CYZone

Government guidance funds (GGFs) are another rather recent instrument geared toward financing high-tech SMEs. Promoted on a national scale from 2014 onward, these funds

[72] State Council, "Notice on Printing and Distributing Several Measures to Help Small, Medium and Micro Enterprises Stabilize Growth, Adjust Structure and Strengthen 关于印发助力中小微企业稳增长调结构强能力若干措施的通知," January 11, 2023, http://www.gov.cn/zhengce/zhengceku/2023-01/15/content_5737024.htm.

[73] Gang Yi, "Report of the State Council on Financial Work - at the Thirteenth Session of the Standing Committee of the Thirteenth National People's Congress on October 28, 2022 国务院关于金融工作情况的报告——2022 年 10 月 28 日在十三届全国人民代表大会常务委员会第三十七次会议上" (SAFE, October 30, 2022), http://m.safe.gov.cn/safe/2022/1030/21646.html.

are encouraged to "guide and drive social capital towards strategic emerging industries by setting up industrial investment funds in a market-oriented manner."[74]

In line with guidance from Beijing, GGFs bring shareholders or limited partners into a structure similar to venture capital and private equity funds.[75] Apparently, a frequent investing practice of GGFs is to operate as funds of funds, which can effectively transfer the political objectives of their investments into other venture capital and private equity firms.[76] It is important to note that local governments have created most GGFs, in part reorientating the Local Government Financing Vehicles that flourished to finance the post-2008 stimulus package.[77]

The limited prospects for SMEs to list publicly is one of the main challenges hindering the growth of a more dynamic Chinese venture capital scene, of which GGF makes up roughly half of the deals and funds raised.[78] Hence GGFs and the stock market reforms mentioned above are strongly complementary, with public listings potentially allowing GGFs to generate hefty returns that can then be re-invested into new firms.[79]

[74] MOF. "Interim Measures for the Administration of Government Investment Funds 政府投资基金 暂行管理办法," 2016, http://www.gov.cn/gongbao/content/2016/content_5051233.htm; NDRC, "Guiding Opinions on Expanding Investment in Strategic Emerging Industries, Cultivating and Expanding New Growth Points and Growth Pole 关于扩大战略性新兴产业投资培育壮大新增长点增长极的指导意见." 2020.

[75] Ngor Luong, Zachary Arnold, and B. Murphy, "Understanding Chinese Government Guidance Funds," March 2021, https://cset.georgetown.edu/publication/understanding-chinese-government-guidance-funds/.

[76] Luong A. and Murphy, "Understanding Chinese Government Guidance Funds"; Yue Yue, Liwei Wang, and Wei Han. "Four Things to Know About the State's Role in China's Private Investment Market." Caixin. October 2020.

Industry experts assesses that state-connected capital makes up for 75 percent of funds raised by leading PE firms come from local and central government-backed funds in China.

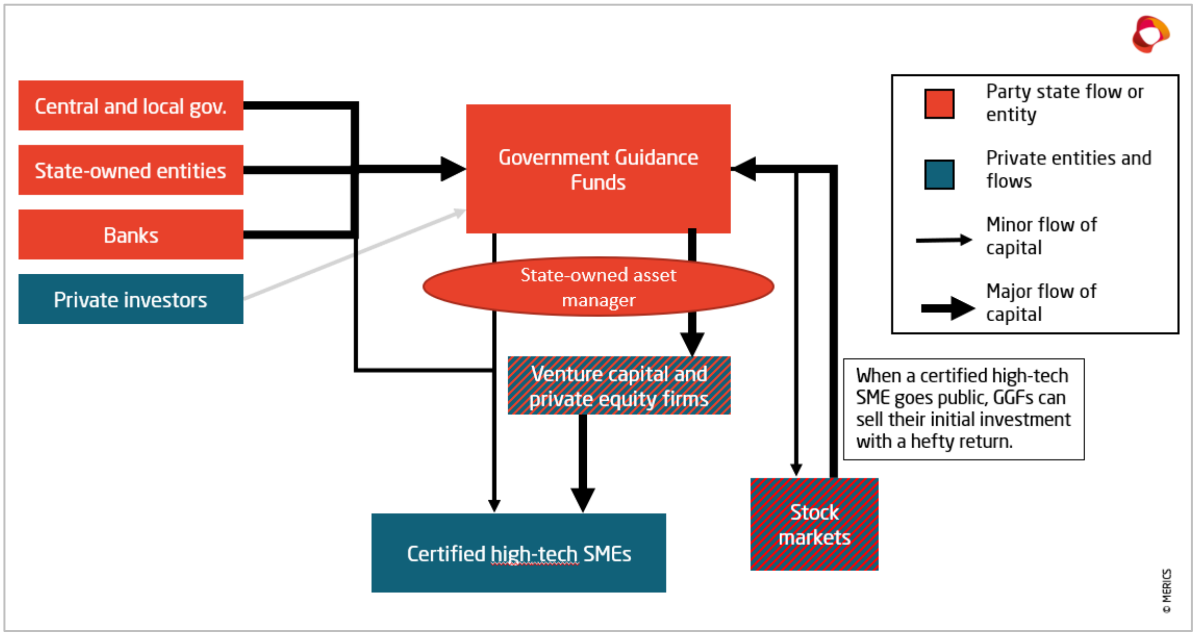
[77] Fenghua Pan, Fangzhu Zhang, and Fulong Wu, "State-Led Financialization in China: The Case of the Government-Guided Investment Fund," *The China Quarterly* 247 (September 2021): 749–72, https://doi.org/10.1017/S0305741020000880; Jianchao Fan, Jing Liu, and Yinggang Zhou, "Investing like Conglomerates: Is Diversification a Blessing or Curse for China's Local Governments?" BIS. January 2021.

[78] Li, Jinlin, Government as an Equity Investor: Evidence from Chinese Government Venture Capital through Cycles (March 17, 2022). Available at SSRN. Colonnelli, Li, Liu, "Investing with the government: A field experiment in China," June 2022 (revised in April 2023), NBER.

[79] Anton Malkin, "China's Experience in Building a Venture Capital Sector: Four Lessons for Policy Makers" (CIGI Papers, 2021), https://www.cigionline.org/static/documents/documents/no.248_0.pdf.

Xiang, D.W. and Li, Z.Y. (2016) Government Equity Investment Guide Fund: Questions, Analysis and Recommendations. Economic Research Reference, No. 19, 22-27.

Exhibit 8: The financial structure of government guidance funds



Source: MERICS

d. A mixed bag of preliminary outcomes, echoing the success of broader reform efforts

By being more targeted, more flexible and more market driven, the accelerator state approach brings China's industrial policy closer to the "embedded autonomy" that economists have identified as a key characteristic of successful industrial ambitions.[80]

A few initial success stories appear to validate China's approach. The accelerator system is still young, but several Little Giants are already touting their achievements in helping to solve China's technological bottleneck problems. One such firm is Little Giant Shandong Yongju Pharmaceutical Technology (山东永聚医药科技) which has developed machines for packaging food and drugs in cooperation with Shantou University.[81] Previously, China relied on imports for the equipment.

In line with sectoral priorities, VC funding shifted slightly away from software and consumer goods, and toward "hard" technologies. The former went from more than 60 percent of VC investment from 2015 to 2019, to around a third over 2020 to 2022. Indeed, about two-thirds of Little Giants are in manufacturing, followed by another 21 percent in scientific research and technical services.[82] The sectoral distribution of listed Little Giants

[80] Juhasz, Lane and Rodrik, "The new economics of industrial policy" (draft), Annual Review of economics, August 2023. https://drodrik.scholar.harvard.edu/sites/scholar.harvard.edu/files/dani-rodrik/files/the_new_economics_of_ip_080123.pdf. Reda Cherif and Hasanov Fuad, "The Return of the Policy That Shall Not Be Named: Principles of Industrial Policy," IMF, Working Paper No. 2019/074, March 2019, 79.

[81] Sina, "Zibo: 'Stuck Neck' Technology Achieves 'Little Giant' Enterprise 淄博：'卡脖子'技术成就'小巨人'企业," October 17, 2022, https://k.sina.com.cn/article_1893761531_70e081fb02002gcjb.html#/.

[82] Weibin Zheng, "More than 60% of Specialized and New 'Little Giant' Enterprises Are Concentrated in the Manufacturing Industry | Xinjing Think Tank 超六成专精特新'小巨人'企业集中在制造业 | 新京智库," *Sina*, November 14, 2022, https://news.sina.cn/2022-11-14/detail-imqmmthc4473666.d.html.

shows that their technological focus is aligned with Beijing's industrial policy priorities. As of the end of 2022, the top three sectors of 624 listed Little Giants were machinery (19 percent), electronic equipment (15 percent) and chemicals (13 percent). And the end goal seems to be well understood too, as 318 of 719 annual reports from 2021 of publicly listed Little Giants mention the term domestic substitution (国产替代).

Indeed, it seems more financial resources are going toward high-tech SMEs. The share of micro, small and medium enterprises in total bank loans has steadily risen since hitting a low point in mid-2019. More volatile, the share of capital raised on SME-oriented stock exchanges compared to total stock exchange funding has been rising steadily since late 2018. More anecdotally, in 2022, 40 percent of new listings on the Shanghai, Shenzhen and Beijing stock exchanges were made by Little Giant companies.

Some sectoral analyses have supported such an efficiency gain by switching to GGF-driven industrial policy.[83] Other researchers have found an uptick in innovation efforts in areas in China with more GGF investments, indicating that they create a "compete-for-financing" effect in innovation.[84]

Evidence of serious flaws have also emerged. MERICS colleagues have found a marginal but significant number of selected Little Giants that do not pass the selection criteria because, for instance they are not SMEs or their recent revenue or profit growth rate was too low.[85] The IMF has suggested that credit policies towards micro, small and medium enterprises could be used simply as window dressing to channel additional funding to the housing market and large firms through shell companies.[86]

In addition, running counter to the original ambition and various later efforts, the vast majority of limited partners among GGFs are SOEs, local governments or other public institutions.[87] And indeed, anecdotal information depicts a bleak picture of local political distortions running high in the management of GGFs.[88] Some researchers have found significant underperformance and distortions from GGFs, especially at the local level.[89]

[83] Xin Tong and Xiaomeng Wan, "National Industrial Investment Fund and China's Integrated Circuit Industry Technology Innovation," *Journal of Innovation & Knowledge* 8, no. 1 (January 2023): 100319, https://doi.org/10.1016/j.jik.2023.100319.

[84] Chen, Joy and Gong, Kaiji and Li, Jinlin, "Industrial Policy in a New Era: Government Venture Capital in the U.S.-China Trade War" (July 2, 2023). Available at SSRN: https://ssrn.com/abstract=4218297 or http://dx.doi.org/10.2139/ssrn.4218297

[85] A. Brown, F. Chimits, G. Sebastian (2023). "Accelerator state: How China fosters `Little Giant` companies." MERICS Report. MERICS.

[86] "People's Republic of China: Selected Issues," *IMF Staff Country Reports*, *2022*, IMF, February 2023 (see para. 33, p. 41).

[87] Ibid.

[88] Yifan Wei, Yuen Yuen Ang, and Nan Jia, "The Promise and Pitfalls of Government Guidance Funds," *The China Quarterly*, August 25, 2022, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4200771.

[89] Li, Jinlin, Government as an Equity Investor: Evidence from Chinese Government Venture Capital through Cycles (March 2022). Available at SSRN. Kajitani, K, K Chen and K Mitsunami (2022), "How Do Industrial Guidance Funds Affect the Performance of Chinese Manufacturing Enterprises?" RIETI Discussion Paper Series 22-E-110. Colonnelli, Li, Liu, "Investing with the government: A field experiment in China", June 2022 (revised in April 2023), NBER.

Nevertheless, multiple recent policy documents indicate an ambition to double down on GGFs to pursue industrial objectives.[90] Jin Zhuanglong, the Minister for Industry and Information Technology, has underlined the need to "give full play to the guiding role of industrial investment funds."[91] High-level policy documents on the cultivation of SMEs underlines the key role of GGFs in supporting high-tech SMEs and manufacturing.[92]

III. The EU has implemented instruments to tackle complex support schemes

Beyond the well-known divergences on the dispute-settlement mechanism, the EU and the US have grown dissatisfied with the WTO rule book that, with China in mind, they deem unsuited for dealing with distortions. The WTO rule book, approved in 1994, sets a high burden of proof before countries are allowed to put tariffs on subsidized goods. What's more, the WTO transparency obligations on subsidies are toothless and poorly respected. Subsidization through below-market financing – in the form of cheap loans or cheap equity – or through below-market inputs is also hard to demonstrate at the WTO. The WTO rules do not properly cover subsidies for production sites in third countries or those channelled through a state-guided entity. The rules around coercive technology transfers and currency manipulation could also be considered not stringent enough against such distortions. On top of this, the rules do not cover the service sector at all.

Correspondingly, the EU, in line with its internal practices and preferences, has been proactively bolstering its approach to preserving a level playing field against Chinese distortions.[93] As early as 2017, a first-of-its-kind, EU official 477-page report listed the "significant distortions" taking place in China, ushering in a new method for the use of EU trade defense instruments. Since then, European tariff sanctions on Chinese goods have increased substantially.[94]

[90] The last two CCP Congress reports (October 2022 and October 2017) underlined the need for the CCP to "guide the development of the non-public sector" as a core dimension of the socialist market economy. In the section on technology, the current five-year plan published in 2021 calls to "encourage the development of angel investment and venture capital and make better use of the role of venture capital guidance funds." The MIIT recently mentioned as part of its top priorities for 2023, "deepen the integration of industry, give full play to the driving role of investment funds, and guide social capital to increase investment in manufacturing." The experience of the Hefei government in spurring state-investments in tech-intensive firms and especially SMEs was publicized through a series of articles in late 2022 in The People's Daily.

[91] Zheng Wang, "Authoritative Interview: All-out Effort to Promote a Positive Recovery and Steady Rebound of the Industrial Economy 权威访谈：全力推动工业经济积极恢复、稳步回升." *People's Daily.* January 2023.

[92] "9. Improve financial, fiscal and talent policies and measures. Give play to the role of government guidance funds, and encourage private capital to invest in high-quality enterprise cultivation funds." ("Accelerating the Cultivation and Development of High-quality Manufacturing Enterprises." MIIT, MOFCOM, SASAC. June 2021)

"All local departments in charge of industry and information technology and intellectual property management departments should make full use of special funds for the development of SMEs." (Notice on Several Measures for Intellectual Property Rights to Help the Innovation and Development of Specialized, Specialized and New SMEs, MIIT, November 2022)

[93] A level playing field is a situation in which market participants "compete on an equal footing" (OECD). Discriminative state interventions such as specific subsidies, regulatory discrimination, and national preference are the usual culprit for tilting the playing field.

[94] M. Huotari, S. Jean. « Bolstering Europe's Economic Strategy vis-à-vis China ». Conseil d'analyse économique. Juin 2022.

To overcome the uncertainty around the non-market economy status of the PRC at the WTO after 2015, the EU has developed its own fact-based country and sector-specific assessments, which has been recognized as WTO-compliant. In addition to its legal capacities, the EU strengthened its administrative ability by creating the position of a Chief Trade Enforcement Officer in 2020, with dedicated personnel and a mandate to enforce international trade rules. Since 2018, EU trade defense instruments have started to target new distortions. The lack of labor-union diversity, in addition to political influence through CCP cells in firms or CCP members in top management, subsidized inputs and restrictions on exports of raw materials have been cited to justify the classification of Chinese sectors as non-market-based.

The CCP presence within entities as well as a declaration of allegiance to party-state initiatives are also used as grounds to categorize those as public bodies. In addition, below-market financing and preferential input prices (including land, electricity, or minerals) have also been taken into account when establishing tariffs on Chinese subsidized products. Anti-subsidy investigations have led to tariffs for transnational subsidies provided to a Chinese firm for production in third markets before being exported to the EU. Economic and Trade Cooperation Zones under the Belt and Road Initiative have been targeted explicitly.

A new regulation enables EU authorities to also tackle state-supported Chinese firms producing and operating on the European market, including for mergers and acquisitions. The new foreign subsidy instrument approved in late 2022 and in place since summer 2023, but not yet fully tested, explicitly covers distortions not covered by the WTO. More specifically, this enables the European Commission to sanction foreign support to players operating on the European market for the entire service sector, but also potentially for any production in Europe, as well as any merger or acquisition and public procurements.

IV. Recommendations

1. **Complete the refining of the US trade defense toolbox and implement more forceful actions against Chinese-subsidized imports into the US, while distinguishing a level-playing-field from security-related instruments.** So far, most of the Chinese distortions have been de facto treated in the US through security-related measures and domestic subsidies. Trade defense tools have been more marginal in the US response. Indeed, they might be more limited in only protecting the national market from such distortions, whereas security-related measure and subsidies have consequences on foreign markets too. However, for a more comprehensive approach trade defense tools offer a valuable alternative in sectors less related to security. Inspired by the European approach, US instruments could be refined to tackle non-market economies, transnational subsidies or even distortions in investments and services.

2. **Increase the understanding and monitoring of Chinese industrial distortions.** Chinese industrial efforts deserve more attention, for our own policy reaction(s) obviously, but potentially also occasionally for policy inspiration. While OECD countries cannot and should not reproduce the PRC's toolkit on public intervention throughout society, the

scale and the innovative dimension of industrial policy in China can be very informative. And many like-minded partners do not have the capacity to conduct a thorough and up-to-date analysis of Chinese efforts and successes.

3. **Domestic industrial policy might be a practical response for national firms to fight Chinese competition in third markets, but a credible alternative rulebook for international exchanges will also be necessary to respond to the broader challenges posed by the PRC**. This can be conceived as a post-WTO or WTO-plus framework. Not that such an alternative is easily within reach. However, in the long term, partners will need predictability and fairness for them to engage in deeper interactions.[95] Given the bargaining power and the size of the US, partners will need some form of a rule-based system. And with no easy solution in sight, it is better to start sooner rather than later.

4. **An iterative, bottom-up approach, building on specific areas of converging analysis and preferences, could be more fruitful both in terms of concrete outcomes as well as in terms of trust building**. OECD countries diverge fundamentally on key issues and there is a considerable degree of uncertainty among many partners surrounding the desired comprehensive system. Aiming at a comprehensive new rulebook for an international level playing field in trade would require tremendous efforts for a very uncertain outcome. The past deliverables of the US-Japan-EU trilateral on transparency and on the treatment of SOEs and public bodies offer solid starting points.[96]

   Other areas of possible convergence of interest and preferences span from:
   - the treatment of developing countries within such a framework (or a well-calibrated special and differentiated treatment),
   - the rules around trade restrictions related to global commons (and especially the environment),
   - the treatment of non-market economies,
   - and the extension of level playing field instruments to services.

[95] The EU met the new US administration with an ambitious cooperation proposition for a renewed rules-based liberal order. It intends to "be the linchpin of a new global alliance of like-minded partners," based on "common values of fairness, openness and competition" and "centered on areas where our interests converge, our collective leverage can best be used" (European Commission (2020). EU-US: A new transatlantic agenda for global change. European Commission). Interestingly, the EU-US Trade and Technology Council also intends to "coordinate approaches to key global trade, economic, and technology issues" in order to "better protect our businesses and workers from unfair trade practices." A working group of the council is dedicated to "global trade challenges," largely to tackle Chinese distortions. No deliverables have been produced or even rumoured on those matters so far.

[96] The discussions on the WTO rules launched in 2017 between the EU, the United States, and Japan made progress, but seemingly stopped in January 2020. This trilateral framework was created to strengthen their "commitment to ensure a global level playing field." The discussions were structured around transparency, subsidy, and state-owned-enterprises (SOEs). These have led to joint communiqués and formal propositions. (see Office of the United States Representative (2017). Joint Statement by the United States, European Union and Japan at MC11). One outcome was a joint proposal on transparency obligations at the WTO, centred on raising the cost on non-compliance to notify subsidies – a poorly observed obligation that lacks any serious enforcement. The three sides also agreed upon a proposition regarding subsidies in January 2020, never made public as the trilateral cooperation froze as the US imposed new tariffs on the EU. The update apparently included a broader scope for the most harmful – and thus prohibited – subsidies, a softening of the burden of proof of the complaining party and more enforceable rules on subsidies through preferential prices, credit, or equity.

OPENING STATEMENT OF ADAM WOLFE, EMERGING MARKETS ECONOMIST, ABSOLUTE STRATEGY RESEARCH

COMMISSIONER GLAS: Thank you. Mr. Wolfe.

MR. WOLFE: Thank you, Chairwoman Cleveland, Commissioner Glas, all the members and staff of the commission. Thank you for the invitation to testify today. In my testimony, I'd like to emphasize four points.

First, China's development objectives shifted dramatically in 2020 in ways that are still not widely appreciated. In the previous two five-year plans, increasing the relative size of the service sector was a top priority. But in the current plan, maintaining a relatively large manufacturing sector and becoming the global leader in seven strategic technologies are now the state's primary economic targets.

This change in priorities had economic and geopolitical motivations. The economic argument was basically that manufacturing tends to be more productive than construction or services, so redirecting economic resources to the more productive sector would help China ease its economic slowdown or ease the economic slowdown that would inevitably come from a shrinking population and a maturing capital stock.

The geopolitical motivation was both defensive and offensive in nature. On the defensive side, China became more concerned about its vulnerability to chokepoint technologies after the U.S. imposed a denial order on ZTE and later sanctioned Huawei. This prompted efforts to bolster China's self-reliance in technology.

In terms of offense, though, China's leaders have long maintained a view that the world is in the early stages of some sort of technological revolution and, if Chinese firms become the dominant players in these emergency technologies, that will somehow bump China to a global leadership role. And this was the motivation for the strategic emerging industries program in 2009, which later became the Made in China 2025 initiative. And the targeted sectors have remained consistent throughout: green industry, new energy, next-generation IT, biotechnology, high-end machinery, new materials, and electric vehicles.

The problem with this new development strategy is that holding on to a large manufacturing sector would require China to lean against the normal pattern of economic development, which we typically see the service sector share GDP increase over time. Economic theory and past precedents from other countries suggest that the only way that China will be able to achieve this is by ramping up its exports, which brings me to the second point that I want to emphasize: this new development strategy seems destined to fail. China's economy is just too big to make it work. For one, China is already the world's largest manufacturer and exporter, accounting for 30 percent and 15 percent of the global total, respectively. And the rest of the world will find it difficult to absorb a larger share of exports from China.

China's exports have risen only modestly relative to its own GDP since 2019, but that's felt like a deluge to the rest of the world with China's global export share rising by two percentage points. A further increase is likely to be met with further increases in trade protectionism.

China's scale will also limit the amount of growth that it can juice out of exports anyway. China's trade-to-GDP ratio has halved since 2007, in line with the typical pattern of development that you see for super-large economics. That means that its exports would have to rise at an implausibly fast pace to hit Xi Jinping's implicit goal of four percent, four-and-a-half percent growth per annum over the next decade.

Manufacturing is also less labor intensive than construction or most services. So reorienting the economy towards manufacturing could be to net job losses, at least in the early stages of this transition. And another challenge to China's pivot back to manufacturing will come from the government's finances. The collapse of the property market means that local government land sale revenues have fallen sharply, which could eventually undermine the state's ability to subsidize the industrial sector, at least without major fiscal reforms.

The third point I want to emphasize is that this failure does not appear to be imminent. In fact, in some ways, China's domestic weakness is boosting its export competitiveness. Weak domestic demand has exposed excess industrial capacity, pushing down producer profit margins. And it's also pushed down product prices in renminbi terms. And because this economic weakness has spooked international investors, capital outflows has pushed down China's exchange rate, as well. As a result, the renminbi is nearly as cheap as it was in the mid-2000s based on some measures of its real effective exchange rate. These factors have encouraged Chinese firms and multinational firms producing in China to dump their excess capacity in the global market, and they're able to do so at even cheaper prices due to the renminbi's depreciation.

Now, the final point I would like to emphasize is that there's no reason to believe that the U.S. will be immune to the global impact of China's increased export competitiveness. If China gains global export share by dumping its excess capacity and improving its competitiveness in some emerging technologies, the impact on the U.S. will likely be similar to that of the rest of the world. One reason for this is that the U.S. does not appear to have decoupled in any significant way from China. The 25-percent tariffs imposed on Chinese imports in 2019 have probably not led to the decline in imports as recorded in the U.S. Customs data. China reported sending, roughly, the same amount of tariff goods to the U.S. in 2022 as it did in 2018, while U.S. Customs reported an $80 billion decline in imports from China in those product categories.

This and other evidence suggest that systemic tariff avoidance has led to a substantial undercutting of U.S. imports from China. China is still likely the largest provider of U.S. imports with its share having only fallen to about 17 percent in 2023, not the 14 percent that's officially recorded.

Additionally, while final production for some goods may have shifted out of China to places like Vietnam and Mexico, the value added that's embedded in those products from China does not appear to have declined significantly. U.S. supply chains have just lengthened by in step, arguably making them more fragile.

Thank you for your time. I'll conclude my remarks.

PREPARED STATEMENT OF ADAM WOLFE, EMERGING MARKETS ECONOMIST, ABSOLUTE STRATEGY RESEARCH

Testimony before the U.S.-China Economic and Security Review Commission

Consumer Products from China: Safety, Regulations, and Supply Chains

March 1, 2024

Adam Wolfe

Emerging Markets Economist, Absolute Strategy Research

Chairman Cleveland, Commissioner Glas, all the members and staff of the Commission, thank you for the invitation to testify before the Commission. In my testimony today, I would like to emphasize four points.

First, China's development objectives shifted dramatically in 2020 in ways that are still not widely appreciated. Maintaining a relatively large manufacturing sector and becoming the global leader in seven strategic technologies are now the state's primary economic targets. But holding on to a large manufacturing sector will require China to lean against the normal pattern of economic development. The only way it will be able to achieve this is by ramping up its exports.

Second, this new development strategy seems destined to fail. China's economy is just too big to make it work. China's exports have risen only modestly since 2019 relative to its own GDP, but it has felt like a deluge to the rest of the world. A further increase is likely to be met with trade protectionism. And it would take an implausibly large increase in its exports to achieve China's growth targets because it, like all large economies, has a relatively low trade-to-GDP ratio. The strategy also won't create enough jobs, and the government's resources to subsidize the manufacturing sector are shrinking.

Third, that failure does not appear to be imminent. In the short term, weak domestic demand, chronic excess capacity, and a cheap currency could help China gain even more global export share. Producer prices are falling fast in renminbi terms, and they're falling even faster in dollar terms, making Chinese goods more competitive globally.

Fourth, there is no reason to believe that the US will be immune from the global impact of China's increased export competitiveness. Efforts to decouple or de-risk from China have come to little more than increased tariff avoidance and longer supply chains.

China's pivot back to manufacturing

China's Five-Year Plan for 2021-2025 signaled a radical shift in the state's development objectives. Increasing the service sector's share of GDP was one of four headline economic development targets in the previous plan, and one of three in the plan before that. But that goal was dropped completely for 2021-25. The explanation for its removal is buried in a single sentence in chapter 8, which said China should maintain the manufacturing sector's share of GDP going forward.[1] The following chapter also set a target to boost the Strategic Emerging Industries' share of GDP from about 12% in 2020 to more than 17% by 2025.[2] Most of the targeted high-tech industries would be included in the manufacturing sector.

This pivot back to manufacturing, with a focus on a few high-tech industries, was motivated by two concerns. The first focused on productivity and growth. The relative decline of the manufacturing sector over the previous two Five-year Plans may have contributed to a decline in China's GDP growth rate. Growth slowed from 9.6% in 2011 to 6% in 2019 while the manufacturing sector's share of GDP fell from 32% to 27%.[3]

The decline in China's total factor productivity (TFP) over this period was largely due to an increase in investment in real estate and infrastructure. TFP for the business sector did not decline[4]. Presumably, if a larger share of savings had instead been invested in manufacturing, productivity growth would not have deteriorated to the same extent. Faster productivity growth will be needed to achieve China's development targets, given its deteriorating demographics and maturing capital stock.

Geopolitical concerns were the other motivation. Fears about China's vulnerability to imported "chokepoint" technologies spiked after the US imposed a denial order on ZTE in 2017, a telecoms firm, and later sanctioned Huawei, another telecoms firm. That's why the plan calls for "self-reliance" in science and technology and the "independent controllability" of the industrial sector. Or, as President Xi Jinping put it, "I've always said there are two critical areas for China: one is to safeguard our rice bowl, and the other is to build up manufacturing."[5]

But China's geopolitical motivations were not only defensive. From its start in 2009, the Strategic Emerging Industries program was aimed at improving China's international power. As a 2010 State Council planning document explained, "to occupy a favorable position in future international competition, China must accelerate the development of the Strategic Emerging Industries."[6] China views the technological competition with the US as an extension of its geopolitical competition.

To be sure, the plan for China's pivot back to manufacturing didn't call for a return to the export-led development model used in the 1990s and 2000s. The new "dual-circulation strategy" called for

[1] "The 14th Five-Year Plan for National Economic and Social Development of the People's Republic of China and the Outline of Long-Range Goals for 2035 (中华人民共和国国民经济和社会发展第十四个五年规划和 2035 年远景目标纲要)", Xinhua, March 13, 2021. https://www.gov.cn/xinwen/2021-03/13/content_5592681.htm
[2] The strategic industries listed in the Five-Year Plan are new generation IT, biotechnology, new energy, new materials, high-end equipment, new energy vehicles, environmentally friendly products, and aerospace and marine equipment.
[3] Data for 2020 are excluded due to distortions from the pandemic and because policymakers would not have had the full 2020 data when drafting the 14th Five-Year Plan. Data are from the National Bureau of Statistics accessed through LSEG Datastream on February 13, 2024.
[4] Herd, Richard. 2020. "Estimating Capital Formation and Capital Stock by Economic Sector in China." World Bank.
[5] Du, Shangze. "China cannot lack manufacturing at any time (任何时候中国都不能缺少制造业)," Qiushi, March 6, 2023. http://www.qstheory.cn/qshyjx/2023-03/06/c_1129415963.htm
[6] "State Council Decision on Accelerating the Cultivation and Development of Strategic Emerging Industries (国务院关于加快培育和发展战略性新兴产业的决定)," Office of the State Council, October 18, 2010. https://www.gov.cn/zwgk/2010-10/18/content_1724848.htm

domestic demand to be the main growth driver, with external demand playing a secondary role.[7] But the plans to boost domestic demand mostly focus on optimizing the domestic market, not expanding the social safety net or increasing the redistribution of income. Instead, factor market reforms are supposed to lead to a more productive allocation of resources[8], while plans for a national unified market are supposed to help the strongest companies achieve greater scale.[9]

Reforms along these lines would likely boost China's TFP and thus its domestic demand. But they would do little to adjust the distribution of income, so would likely have little impact on the consumption share of GDP. But reshaping the economy in these ways would create a more powerful training ground for firms seeking to go abroad. That would be aided by efforts to align domestic product standards with international norms so that a single production line can serve both markets.[10]

This is important, because economic theory and precedent suggest that domestic demand won't be enough to halt the decline of China's manufacturing share of GDP. That would require higher exports.

Challenges to China's pivot, in theory and practice

Several theories suggest the service sector should rise as a share of GDP as an economy matures. Beyond a certain development stage, when "surplus" labor in the agricultural sector has been exhausted, wages in the tradeable goods sector should rise in line with the improvement in output per-worker.[11] But wages will also rise at a similar pace in the non-tradeable sector because workers can move between the two.[12] That implies that aggregate spending will gradually shift toward non-tradeable services, where output per-worker tends to rise more slowly, leading to higher relative services prices. William Baumol called this process the "cost disease" because it results in a lower potential growth rate.[13]

This development pattern is well documented in the historical data. Manufacturing typically declines as a share of GDP and employment around the time an economy reaches middle-income status, although that tipping point may be occurring earlier lately.[14] So far, China has followed this pattern. Its

[7] See part 4, chapters 12-14 in The 14th Five-Year Plan: https://www.gov.cn/xinwen/2021-03/13/content_5592681.htm

[8] "Notice of the General Office of the State Council on Issuing the Market-oriented Allocation of Factors (国务院办公厅关于印发要素市场化配置)," General Office of the State Council, January 6, 2022. https://www.gov.cn/zhengce/content/2022-01/06/content_5666681.htm

[9] "Opinions of the Central Committee of the Communist Party of China and the State Council on Accelerating the Construction of a National Unified Market (中共中央 国务院关于加快建设全国统一大市场的意见)," Xinhua, March 25, 2022. https://www.gov.cn/zhengce/2022-04/10/content_5684385.htm

[10] "Several measures to accelerate the integrated development of domestic and foreign trade (关于加快内外贸一体化发展的若干措施), General Office of the State Council, December 11, 2023. https://www.gov.cn/zhengce/content/202312/content_6919596.htm

[11] This is commonly called the Lewis turning point; most estimates suggest China reached this point sometime between 2004 and 2014. Lewis, W. A., 1954. "Economic Development with Unlimited Supplies of Labour," The Manchester School, 22, pp. 139–92.

[12] This the Balassa-Samuelson effect. Balassa, Bela. 1964. "The Purchasing-Power Parity Doctrine: A Reappraisal," Journal of Political Economy, Volume 72, Number 6, December.

[13] Baumol, William J. 2012. *The Cost Disease.* New Haven: Yale University Press.

[14] Rodrik, Dani. 2015. "Premature Deindustrialization," National Bureau of Economic Research Working Paper, February. https://www.nber.org/papers/w20935

manufacturing sector began to decline as a share of GDP in 2011 and employment in 2012 shortly after crossing the World Bank's threshold for upper-middle income status in 2010[15].

Still, a handful of countries have maintained a large manufacturing sector even with GDP per-capita levels above China's. The Czech Republic, Germany, Korea, Slovenia, and Taiwan all have higher per-capita GDP levels than China and their manufacturing share of GDP is close to or above China's. Critically, they've all maintained a stable or rising manufacturing share of GDP over the past three decades.[16]

These countries have three things in common that set them apart from other developed economies: a high national savings rate, a large current account surplus, and an elevated trade-to-GDP ratio (Charts 1 & 2).

A high savings rate was needed to move up the value-added ladder since this requires a lot of investment. But boosting savings required suppressing consumption, which resulted in low domestic absorption rates and higher net exports. Exports also allowed these countries to overcome the relative price dynamics that otherwise would have shrunk the manufacturing sector's share of GDP. Even as their domestic consumption shifted toward services, they continued to ramp up goods production by selling the excess abroad. Finally, generating much growth from an economic model along these lines required a large export-to-GDP ratio.

China's massive scale will make this a difficult path for it to follow. It accounts for about 30% of the global value added from manufacturing, roughly equal to the US and EU's shares combined. It became the world's largest exporter in 2009, and its global export share rose to about 15% in 2023 (Chart 3).[17] It may be difficult for the rest of the world to absorb more exports from China, let alone a larger trade surplus. China's trade surplus peaked at 7.4% as a share of its own GDP in 2007, and the ratio slipped to 4.6% in 2023. But because China's economy has grown faster than the rest of the world, its trade surplus as a share of global GDP rose from 0.5% in 2007 to about 0.8% in 2023[18].

China's scale will likely undermine the state's attempt to pivot back to manufacturing in two ways. First, holding the manufacturing sector's share of GDP steady may seem like an incremental shift in China's development pattern from Beijing's perspective, but it has already felt like a deluge to the rest of the world. China's global export share has risen by two percentage points since 2019. The world is unlikely to sit back and let another "China shock" happen. The European Commission's investigation into China's electric vehicle subsidies is likely to be the first of many trade protectionist efforts aimed at China's new development strategy.[19]

[15] Data from World Bank's World Development Indicators, accessed via LSEG Datastream.
[16] Japan also has a relatively large manufacturing sector, but its share has declined since 1991. Ireland, Singapore, and Switzerland also have relatively large manufacturing sectors, but the industrial share of their employment is not elevated, suggesting the sector's output share is overstated. All the data in this paragraph and the next are from the World Bank's Open Data Catalog, supplemented with national data for Taiwan. https://datacatalog.worldbank.org/home
[17] Data from the IMF's Direction of Trade database, accessed via LSEG Datastream.
[18] National data from China and the IMF's estimate of global GDP, accessed via LSEG Datastream
[19] "Commission launches investigation on subsidised electric cars from China" European Commission, October 4, 2023. https://ec.europa.eu/commission/presscorner/detail/en/ip_23_4752

China's heft will also limit the amount of growth that it can generate with a manufacturing-led development strategy. Economic scale tends to be negatively correlated with the trade-to-GDP ratio.[20] Here, too, China has fit the typical pattern. Its ratio fell from 64% in 2006 to 31% in 2020.[21] The ratio has risen slightly since, reaching 34% in 2023. But it will be arithmetically impossible for China to generate much export-led growth if its total trade remains in the 30-40% of GDP range. And if China tries to rely on domestic demand to support its manufacturing sector, then the dynamics of Baumol's cost disease will kick in, just as they had in the decade to 2020, when the composition of GDP shifted toward services.

In short, it seems likely that China's attempt to pivot back to manufacturing will spark a significant global pushback and fail to generate sufficient growth to meet President Xi's implicit goal of doubling the 2020 real GDP level by 2035, which would require 4.5% annual growth.[22]

Nevertheless, China may gain further global export share over the next few years, helped by the government's industrial policies. These efforts have already pushed China to the technological frontier in some sectors and have contributed excess capacity in nearly every industry.

Policies to support manufacturing

The pivot back to manufacturing has been supported by several government policies. Most prominently, the People's Bank of China (PBoC) has incentivized state-owned commercial banks to ramp up lending to manufacturers. Annual loan growth to the manufacturing sector has jumped to 26% on average since 2020, up from 5% in the five years through 2019. Meanwhile, total lending slowed to 13% from 16% before due to a sharp slowdown in real estate lending.[23]

Re-lending windows are one tool for this. The PBoC lends funds to commercial banks at below-market interest rates if they lend the proceeds to targeted sectors. Since 2020, the PBoC has opened re-lending windows to support green energy, high-tech manufacturing, and equipment upgrades. In total, these programs could support bank lending of ¥2.5 trillion (2% of GDP), of which ¥1.2 trillion was outstanding at the end of 2023.[24]

Other industrial support measures were put in place well before the 2020 policy pivot. The central government's industrial policy efforts started in 2009, with the Strategic Emerging Industries initiative. This was followed by the Made in China 2025 program in 2015. The new program brought new policy goals and support measures, but the targeted industries hardly changed at all. The seven industries that General Secretary Xi highlighted in his 2022 report to the National Party Congress[25] were the same

[20] Kindleberger, Charles P. 1966. *Foreign Trade and the National Economy*. New Haven: Yale University Press.
[21] National data from China, accessed via LSEG Datastream.
[22] Tabeta, Shunsuke and Iori Kawate, "Xi raises prospect of doubling China's GDP by 2035," Nikkei Asia, November 4, 2020. https://asia.nikkei.com/Economy/Xi-raises-prospect-of-doubling-China-s-GDP-by-2035
[23] Calculations based on the medium and long-term lending data from the PBoC accessed via Wind.
[24] "Structural monetary policy tools status (结构性货币政策工具情况表)," People's Bank of China, January 26, 2024. http://www.pbc.gov.cn/zhengcehuobisi/125207/125213/4634692/4634700/5221308/index.html
[25] "Full text of the report to the 20th National Congress of the Communist Party of China," Ministry of Foreign Affairs of the People's Republic of China, October 25, 2022. https://www.fmprc.gov.cn/eng/zxxx_662805/202210/t20221025_10791908.html

highlighted by then-Premier Wen in his speech launching the Strategic Emerging Industries program[26]: green industry, new energy, next-generation IT, biotechnology, high-end machinery, new materials, and electric vehicles. These sectors were chosen because they were expected to become globally important and there was no dominant global leader yet.[27] This could allow China to leapfrog to the technological frontier, or "pass on the curve."[28]

These sectors have received support from government-linked investment funds, tax incentives for research and development, and support for basic research. The Center for Strategic & International Studies estimated that China spent 1.7% of GDP on industrial policy in 2019 whereas every other country in the study spent less than 1% of GDP on such activities[29]. That figure has likely risen since.

In practice, however, China's industrial policies tend to be less coordinated and less targeted than the centralized plans suggest. Most industrial support comes from local governments, primarily through three channels. First, local governments compete to lure industrial firms to their jurisdictions with tax incentives and other benefits[30]. Second, industrial land-use rights are sold at a substantial discount. On average, industrial land sold for ¥260/sq. meter in 2023 compared to ¥4090/sq. meter for residential land-use rights. Third, 47% of local government special-purpose bonds, roughly equivalent to project bonds in other countries, were used to build industrial parks, which are then rented out to firms at a discount.[31]

These measures have substantially reduced the cost of manufacturing in China but have also contributed to its excess capacity due to the duplicative nature of local support.

This is a vulnerability. The on-going property market collapse threatens to undermine local governments' ability to support manufacturers. Their total fiscal revenues, including transfer payments and bond issuance, fell from 31% of GDP in 2019 to 27% in 2023, mostly due to a ¥1.5 trillion decline in land sale revenues.[32] If land sales continue to decline, as seems likely, local governments will eventually be forced to reduce their subsidies.

This, too, is a reason to think that China's pivot back to manufacturing will eventually fail. In the meantime, however, China's economic slump is contributing to its rising global export share.

[26] "Premier Wen Jiabao: Let science and technology lead China's sustainable development (国务院总理温家宝：让科技引领中国可持续发展)", Xinhua, November 3, 2009. https://www.gov.cn/ldhd/2009-11/23/content_1471208.htm

[27] Naughton, Barry. 2021. *The Rise of China's Industrial Policy 1978 to 2020*. Universidad Nacional Autónoma de México.

[28] Yao, Yong, translated by David Ownby. "China's economic future is bright," Reading the China Dream, October 16, 2022. https://www.readingthechinadream.com/yao-yang-on-chinas-economy.html

[29] DiPippo, Gerard, Ilaria Mazzocco, Scott Kennedy. "Red Ink: Estimating Chinese Industrial Policy Spending in Comparative Perspective." Center for Strategic & International Studies. May 2022. https://www.csis.org/analysis/red-ink-estimating-chinese-industrial-policy-spending-comparative-perspective

[30] Ang, Yuen Yuen. 2016. *How China Escaped the Poverty Trap*. Cornell University Press.

[31] Land and bond data were accessed from Wind.

[32] Data are from the Ministry of Finance and National Bureau of Statistics, accessed via Wind.

Weak domestic demand supports Chinese exports

Weak domestic demand has exposed excess capacity, weighed on industrial margins, and contributed to producer price deflation. In 2023, 22% of industrial companies posted a loss for the year, a record high going back to 2002, and industrial profit margins narrowed to 5.6%, a 13-year low[33]. The producer price index (PPI) had fallen on an annual basis for 16 consecutive months as of January 2024[34], a streak that looks likely to continue in the months ahead. Tight margins and falling prices have reduced the cost of Chinese produced goods in the global market.

This has been reinforced by a depreciation in China's exchange rate. Based on purchasing power parity, China's deflation should have translated into a stronger nominal exchange rate to prevent real currency depreciation. Instead, capital outflows caused the nominal exchange rate to depreciate, too. Foreign investors have pulled some of their investments from China, with foreign claims falling in four of the last five quarters through Q3 2023.[35]

As a result, the renminbi is as cheap as it was in the mid-2000s based on some measures of the real effective exchange rate (Chart 4). This was not due to government policy, at least directly. The PBoC has leaned against renminbi depreciation by setting its fixing rate, or the center of the USD/CNY trading band, at stronger levels than the market-based spot rate. State-owned banks have also sold foreign assets to support the exchange rate.[36]

Whether intentional or not, China's pivot back to manufacturing will likely lead to a further decline in its product prices and exchange rate, which will tend to increase its global export share.

Manufacturing is less labor intensive than construction, so shifting resources away from building houses and infrastructure toward manufacturing high-tech products may lead to net job losses during the transition. Plus, changes to the household registration system and rural land-use rights, which are key parts of the factor market reform plan, could lead to a reduction of agricultural employment. The potential boost to the non-agricultural labor force could be substantial. When Japan and Korea were at a China's current per-capita GDP level, agriculture accounted for less than 15% of employment. In China, it accounted for 24% in 2022.[37] Both factors will weigh on wage growth, which could allow producers to further cut product prices.

[33] Data are from the National Bureau of Statistics' "Main Economic Indicators of Industrial Enterprises" database. https://data.stats.gov.cn/english/easyquery.htm

[34] Tan, Clement. "China producer prices dip in January for a 16th month; consumer prices see biggest drop since 2009," CNBC, February 7, 2024. https://www.cnbc.com/2024/02/08/china-producer-prices-dip-in-january-for-a-16th-month-consumer-prices-slip-again.html

[35] Based on the balance of payments data from the State Administration of Foreign Exchange. https://www.safe.gov.cn/en/2019/0329/1496.html

[36] "China state banks selling dollars for second day to support yuan – sources," Reuters, December 6, 2023. https://www.reuters.com/markets/currencies/china-state-banks-selling-dollars-second-day-support-yuan-sources-2023-12-06/

[37] Data from national sources and the Penn World Tables, accessed via LSEG Datastream.

The pivot in practice: how China became the top auto exporter

Looking at how these dynamics are unfolding at the sector-level can help to clarify the global consequences. This section describes how China became the world's largest auto exporter.

China's auto exports surged from 724 thousand cars in 2019 to 4.08 million in 2023, making it the top exporter of passenger cars globally.[38] Some of this increase was due to the government's support for new energy vehicles (NEVs) under its Strategic Emerging Industries initiative. Local governments have also been keen to establish NEV factories in their jurisdictions, resulting in duplicative efforts and excess capacity that has put downward pressure on prices. Meanwhile, reforms to boost domestic competition – cutting purchase subsidies, allowing Tesla into the market without a joint-venture partner, etc. – also helped to improve the quality of Chinese NEVs. NEV exports rose from 31 thousand cars in 2019 to 1.15 million in 2023, of which 27% were Chinese-made cars from Tesla.

Yet most of the increase in China's auto exports came from traditional, internal combustion engine (ICE) cars, which rose from 693 thousand units in 2019 to 2.94 million in 2023 (Chart 5). Two factors explain this spike. First, passenger car exports to Russia rose from $440 million in 2019 to $11.7 billion in 2023 as producers from other countries abandoned the market due to international sanctions. But this only explains a small share of the surge. Exports of cars to the rest of the world rose from $8.2 billion to $66 billion over this period.[39]

The second factor has been more important. Declining demand for ICE cars in China resulted in chronic excess capacity. Producers, most of which are joint ventures with foreign firms, dumped their excess capacity on the global market, a process that was helped by a cheap exchange rate.

This combination of excess capacity, technological advancement, and a cheap currency may lead to similar export surges in other higher value-added products in the coming years. China's lagging-edge semiconductors are a particular concern. Increased government support has helped the industry to expand its capacity.[40] Meanwhile, sanctions on Huawei have turned it into a large, price-insensitive buyer of domestic chips with high quality standards.[41] This will help the industry get up to scale and improve its competitiveness. After which, a cheap currency and excess capacity could see China flood the market with lagging-edge chips by undercutting global prices. This could weigh on margins for chip producers in the rest of the world, including those in the US.

The US has not de-risked its supply chains

US policymakers should not assume that efforts to de-risk the country's supply chains will offer much protection from a surge in higher value-added Chinese exports. For one, US import data likely understate the country's actual imports from China by nearly 25% due to systematic tariff avoidance.

[38] All data in this paragraph are from the China Association of Automobile Manufacturers, accessed via Wind.
[39] Data are from China Customs for exports of HS code 8703. http://stats.customs.gov.cn/indexEn
[40] Strumpf, Dan. "China Chases Chip-Factory Dominance—and Global Clout," Wall Street Journal, July 24, 2022. https://www.wsj.com/articles/china-bets-big-on-basic-chips-in-self-sufficiency-push-11658660402
[41] Wang, Dan. "China's Sputnik Moment?," Foreign Affairs, July 29, 2021. https://www.foreignaffairs.com/united-states/chinas-sputnik-moment

Before 2018, the US regularly recorded imports from China worth 15-20% more than China reported sending to the US. About 10-15 percentage points seems to have been due to China recording a portion of exports that were ultimately bound for the US as going to Hong Kong. The rest was due to different global standards for recording imports and exports. But since 2020, the US has recorded fewer imports from China than China reported sending to the US. This should not be possible.

Mapping the US and Chinese data to the US's Section 301 tariffs by HS code helps explain how this happened.[42] The gap between US-recorded imports and Chinese-reported exports only reversed for the goods subject to the higher tariffs, although it narrowed somewhat for non-tariffed goods (Chart 6). This suggests that tariff avoidance was the primary driver behind the reversal of the discrepancy.

In this instance, the Chinese data are likely more reliable since US-based firms have a financial incentive to understate their imports to avoid paying higher tariffs. As a result, US imports from China may have been understated by $100 billion or more each year since 2020. China's share of US imports probably only fell from 21% in 2017 to 17% in 2023, not the 14% share officially recorded.[43]

Moreover, while the final assembly of some goods has moved from China to India, Mexico, Vietnam, and other locations, the Chinese value-added embedded in these products does not appear to have declined significantly. Instead, a BIS analysis using firm-level data found that US supply chains have lengthened by an additional step, without any additional diversification.[44]

This means that the impact on the US economy from a surge in cheap Chinese exports of higher-value products will be similar to that of the rest of the world. This could undermine US industrial policies aimed at boosting the domestic production of electric vehicles and batteries, green energy, and semiconductors. Even with government subsidies, US firms in these sectors may find it difficult to make a profit if China's excess capacity weighs on global prices.

Policy recommendations for Congress

The US should coordinate with other countries to resist a further rise in China's global export share. China's pivot back to manufacturing may benefit the US in some ways. It could lead to lower inflation and help to make the transition to green energy faster and cheaper. But most countries share similar concerns about the potential for deindustrialization and dependence on Chinese goods.

A coordinated response would be best. The Indo-Pacific Economic Framework for Prosperity is a positive but insignificant step. Multilateral free-trade agreements with tight product, environmental, and labor standards would more effectively level the playing field with China. Congress should approve the Comprehensive and Progressive Agreement for Trans-Pacific Partnership and encourage the executive branch to open negotiations with other regions for similar high-standard agreements.

[42] This was done using the bilateral trade data from the UN Comtrade database, which was mapped to the US Trade Representative's Section 301 tariff lists.
[43] The calculation uses Chinese-reported exports to the US, adjusted to match the pre-2018 relationship with US-record imports from China. National data accessed via LSEG Datastream.
[44] Qiu, Han, Hyun Song Shin and Leanne Si Ying Zhang. "Mapping the realignment of global value chains," BIS Bulletin no 78, October 3, 2023. https://www.bis.org/publ/bisbull78.pdf

The US should not increase its tariffs on Chinese goods any further. The tariffs haven't reduced US dependence on China or harmed China's economy in any significant way. Instead, US-based firms are now engaged in systematic tariff avoidance, and US supply chains have lengthened. Higher tariffs probably wouldn't generate more revenue for the Treasury. Instead, they would likely lead to further efforts to conceal the origin of Chinese produced goods. This would only increase the fragility of US supply chains and make them more difficult to monitor.

Chinese investment into the US should be encouraged, especially in clean energy technologies, as should cooperation between US and Chinese scientists. There are legitimate security concerns about Chinese investment and scientific research. Screening tools should be strengthened. But China is well ahead of the US in several technologies that will be critical for avoiding a climate catastrophe, and Chinese scientists are leaders in several areas of research.

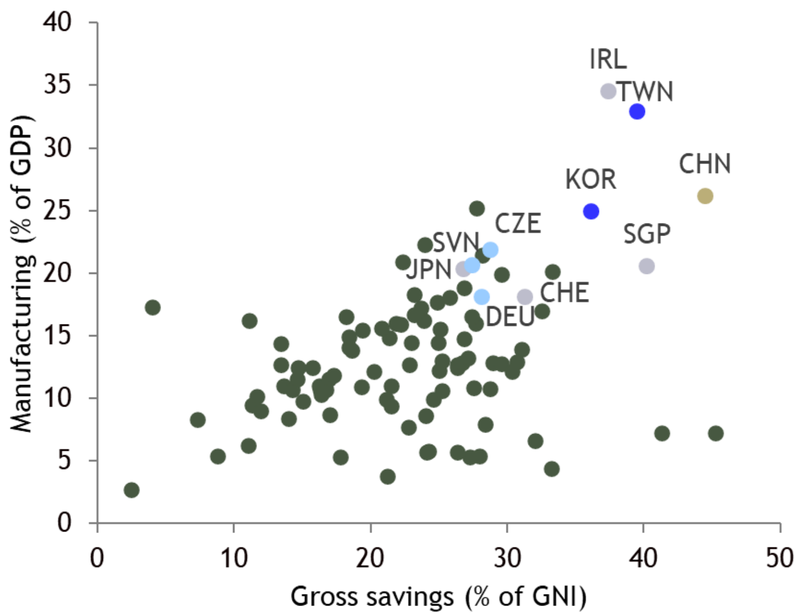
It's time for the US to steal a page from Japan, the Asian Tigers, and China itself by leveraging China's knowledge and knowhow in these sectors by encouraging foreign direct investment in the US, licensing agreements with US firms, and collaborative research with US scientists. It's not too late for the US to catch up and surpass China in these sectors. The best way to do that may be to follow the learning-by-doing process that underpinned the East Asian Miracle.

US policymakers should continue to pressure their Chinese counterparts to boost domestic demand and curtail excess capacity through bilateral dialogue. These conversations do not have to be antagonistic. China's pivot back to manufacturing seems destined to fail as an economic development strategy anyway. But the government may cling to the strategy for longer than it should due to its own security concerns about its supply-chain exposure to the US and its allies.

The US should instead encourage policies that would steer economic resources to the household sector and flatten the distribution of household income. This could provide a boost to consumption, which could lead to higher Chinese demand for US goods.

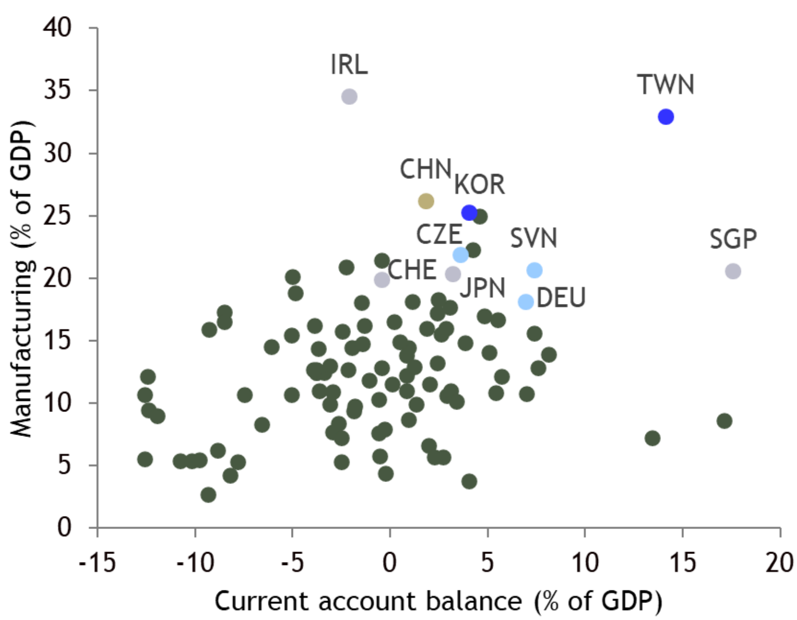
Charts

Chart 1: Manufacturing-oriented economies have high savings (2019)



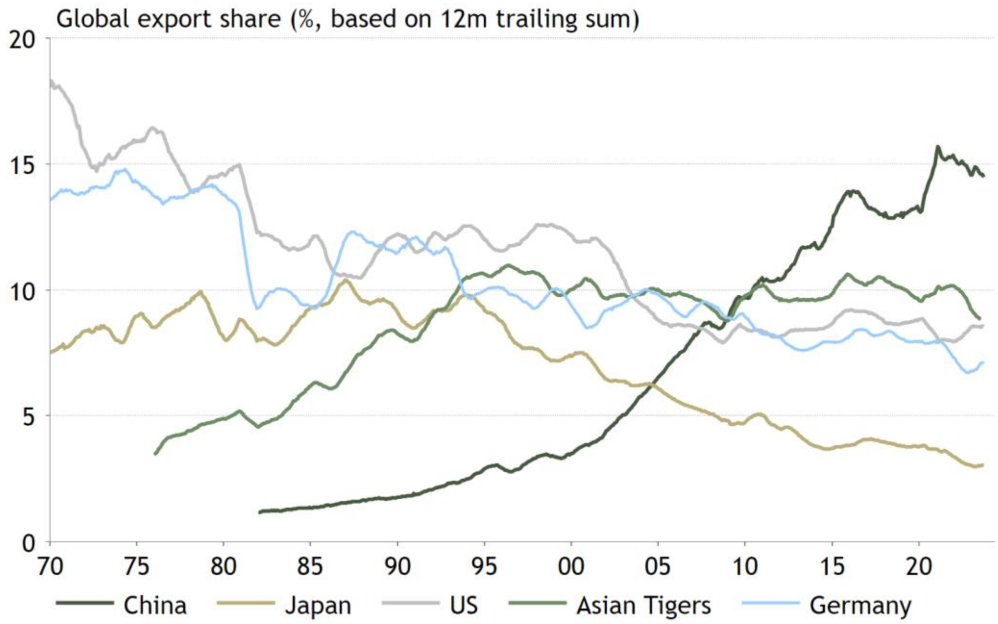
Source: World Bank

Chart 2: Manufacturing-oriented economies have large current account surpluses (2019)



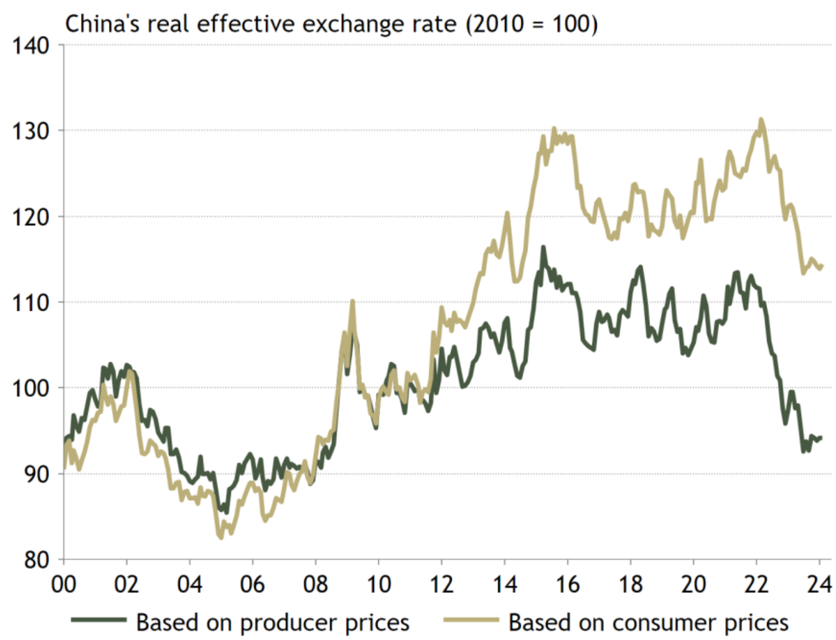
Source: World Bank

Chart 3: China's global export share has risen



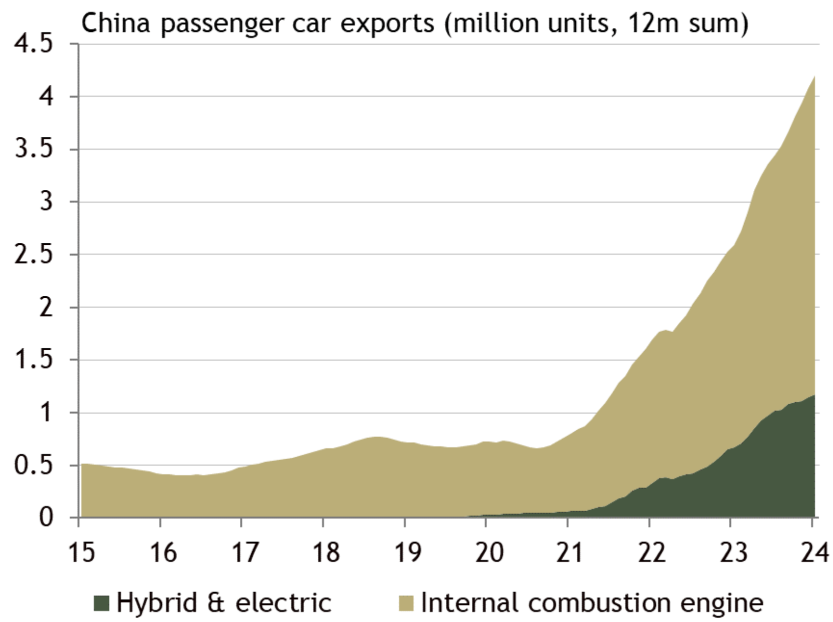
Source: IMF Direction of Trade Statistics, accessed via LSEG Datastream

Chart 4: China's real effective exchange rate has depreciated



Source: JP Morgan, accessed via LSEG Datastream

Chart 5: China's auto exports are mostly ICE cars



Source: China Association of Automobile Manufacturers, accessed via Wind

Chart 6: US imports from China are likely understated due to tariff avoidance

Source: Comtrade, US Trade Representative

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PANEL III QUESTION AND ANSWER

COMMISSIONER GLAS: Thank you all. Thank you all so much for your testimony. We are going to now turn to fellow commissioners to ask questions. I'm going to go in reverse alphabetical order, so let's start with Commissioner Wessel.

COMMISSIONER WESSEL: Thank you all. Very interesting. I heard from Mr. Hanson and Mr. Wolfe, you know, differing approaches or differing assessments, in some ways -- correct me if I'm wrong -- but it felt like you're both arguing in some ways peak China. And, Mr. Hanson, you seem to say that it's growth trajectory in a number of industries may be limited. Mr. Wolfe, I heard you question what its growth trajectory is going to be, and I don't share your optimism, pessimism, however you want to, however or whatever point of view you want to bring to that, when I look at what China is doing in biotech, what they are doing in robotics, what they are doing in new energy vehicles, not just EVs but broader than that, aerospace, the ARJ21, the C919, what they're doing in cloud and many other areas, and that we have somewhat of a new battleground which may be the Global South where I think China is doing fairly well, a lot of that because of price points, a lot of it for other reasons.

Are you arguing, and, Mr. Hanson, start with you, are you arguing about peak China? Help me understand the implications of what you're saying.

DR. HANSON: So to answer that question, it's important to think about is the question will China lose its position of dominance in the global economy in the areas in which it's established that dominance. The answer is no. Is China going to continue to take over market share at the clip that it did during the 90s and early 2000s, during this productivity growth miracle, I think the answer to that is no, too.

COMMISSIONER WESSEL: But just to pull on that, are you talking about vis-à-vis the U.S. or in the West? Again, add the Global South to this and help us think through, you know, the global implications.

DR. HANSON: So you mentioned industries in which China is moving into, and some of those it's going to have a dominant presence like it had in cell phone handsets in the past. Today, for it to do so, it's got to move out of something else. It didn't have to do that before. It had enough resources and it was enjoying that once-in-an-epoch productivity surge that it could take on all markets at once. So now, if China is going to do more of one thing in a big way, it's going to be less of other things in a significant way. So that's one issue.

The other issue is that during that era of -- I don't want to call it frontier capitalization because it wasn't pure capitalization but it was close as China is probably going to get. During that era, the government was kind of not on top of what the private sector was doing in manufacturing. Manufacturing was outside of the government control in a lot of ways, and manufacturing didn't have access to state-owned government banks really. They were relying on the shadow financial system. And the dynamism in all of that growth came from the entry of new firms doing new things, not existing firms improving their operations. China shut down that dynamism, and it shut down that dynamism because it's moved from targeting economic growth, not the Deng Xiaoping era to get rich is glorious. It wants economic growth, it wants technological domination, and it wants party supremacy. It is hard to hit three targets at once consistently, and I think that's the problem it faces.

COMMISSIONER WESSEL: Before I respond, Mr. Wolfe.

MR. WOLFE: I would agree with what Dr. Hanson said that, if you're talking about is it peak China in terms of global value-added in manufacturing or global export share, perhaps we're not quite there yet, but we're nearing that point just because the rest of the world won't be able to absorb all of that capacity from China.

I also think, in terms of growth rates, obviously, we're well past peak China. That happened a decade ago in terms of GDP growth rates. But there are still other ways that China can grow. I think that this growth model that they've adopted, and it's the core to the current five-year plan, is inappropriate for China's economy, but there are more appropriate measures that they've implemented that are also part of this plan in terms of market reforms, factor market reforms that could improve productivity, breaking down the barriers between rural and urban household registrations, and land markets, for example. Those factors would help China to grow over the long run, and there are other ways that China could pivot its growth model to continue to grow in the future.

COMMISSIONER WESSEL: And with the benefit of the Chair, if one looks at the industries that help drive its growth, and, again, many of them as labor intensive, et cetera, from a national security perspective for the U.S., isn't where they are going, the Made in China 2025 and others, that may not contribute the same level of growth, from a national security perspective, aren't those of even greater concern to the U.S.? Mr. Wolfe.

MR. WOLFE: Yes. So I think the seven targeted strategic industries, I think China has long believed that that is its key to vaulting to a global leadership position where, geopolitically, the U.S. would no longer be in a position to dictate terms to China if it was the global leader in these technologies. I think the U.S. has increasingly adopted that view, as well, about these technologies, and that's why the competition is so focused in those areas. Whether or not that is true, if these are the right strategic industries for the future, I think is very uncertain.

COMMISSIONER WESSEL: Okay. Thank you.

COMMISSIONER GLAS: Thank you. Commissioner Sims.

COMMISSIONER SIMS: Dr. Hanson, I appreciated, in particular, you're a little bit of an outlier among the people we've talked to today about comments around Section 301, which is good. I think that's good that we get a different perspective on that, and you, I think rightly, identified the political peril that some would see in even the hint of rolling such things back. But it actually made me think about this as a layman from an economics perspective, think about this in a way that I haven't before, and that is the potential tension that exists in China between a desire to hold on to, I guess, what would be more like traditional manufacturing that they have had, which we have maybe blunted in some ways with 301, maybe not, with also a desire to push into higher-end technology manufacturing.

And I guess, for lack of having, like, a really pointed question around this, I would love to hear from you and others, as well, about how are they thinking about this? Are these things in tension or are they complementary in some ways? It seems to me that they've got, like, competing goals here in those two ways.

And then second to that is, from a policy perspective, if not 301, what other levers may be at our disposal to get at the same issues?

DR. HANSON: So on the 301 issue, you think about the industries that we really want to consider as sensitive. You put semiconductors on there? Absolutely. What about solar panels? What about batteries? The world might be better off if China just massively subsidizes improvement in technology in those areas. We'd love to have cheap solar energy and high-capacity batteries. I understand that this is anathema to lots of folks, the idea that China is going to subsidize its way to market dominance. But market dominance is not, in and of itself, a bad thing. It depends on where that dominance is expressed, and I would draw a big line between something like semiconductors and something like solar panels.

I'm going to leave it to the other panelists to get inside the mind of Xi Jinping. But what I would want to highlight is the way in which Xi Jinping has changed the objectives of the folks who are trying to please him. And this is both captains of industry, this is heads of universities. These are folks who are managing the heads of banks. And that is, in the past, you know, kind of up to around 2010, what was the goal? Become the world's best, beat the West at its own game. What's the game now? Please Xi Jinping. And pleasing Xi Jinping and becoming the world's best, sometimes those go together, a lot of times they don't.

COMMISSIONER SIMS: I'd love to hear more on that. I mean, can you expand on that a little bit more? I mean, what are the --

DR. HANSON: So let me give you an example that's close to home for me, and this is the world of higher education. Higher education is a very important export industry in the United States. I know that's very self-serving of me to say. But we do a good job of selling our services to the world as a whole.

China has tried to make major incursions in there and subsidizes higher education in a very significant way. I advised folks at Tsinghua University and Peking University in the early 2000s about how they could improve their economics departments, and their goal was, in five years, we want to be the equivalent of a top-30 economics department in the United States and then we want to get to 20 and then we -- today, that's not the discussion. The discussion is, among the department chair or the dean, they're also party secretaries for their units, and they are trying to make sure that folks in the organization department are putting good things about them in their files because that means opportunities for promotion later on. The idea of achieving academic success is secondary.

That same mindset replicated in companies in which the CEO is party secretary for the company's party committee or there's somebody very close to the CEO who is. And that distorts how you spend your time and energy and whether you become the best at what you're trying to do or whether you're trying to please folks within the government bureaucracy.

COMMISSIONER SIMS: I'll give back the rest of my time.

COMMISSIONER GLAS: Thank you. Commissioner Price.

VICE CHAIR PRICE: Thank you. And thank you all for your participation today. My line of questioning was very similar to -- it's going to be very similar to Commissioner Sims. So let me, I'm trying to pivot just a little bit.

Mr. Wolfe, in your recommendations, you also say that we shouldn't increase tariffs, and you mentioned it briefly in your given testimony. If you could just touch on that just another minute.

And then for everyone, as we look at the concept of de-risking, whatever that concept actually means, and we work with our global partners on that, what would we need to do to make that work?

MR. WOLFE: I think you would find it difficult, well, it would be difficult to find an economist who would defend tariffs in most instances. And I think that the Section 301 tariffs so far have proven to be highly ineffective, that China has either rearranged supply chains to provide those products to the U.S., or U.S.-based firms have found ways around paying the tariffs anyway and reporting the goods to Customs.

And so I think doing something that hasn't worked but doing it harder isn't going to get a different result, and that would be my recommendation of why not to just keep doing the same thing. I think what would probably work better is broader coordination with other countries, looking at product standards or supply chain reporting standards, and coordinating a response that would make it more difficult for China to find ways around the restrictions that the U.S. is trying to impose.

VICE CHAIR PRICE: De-risking? Anyone want to take a chance at that?

MR. CHIMITS: I'll jump on this one. That resonated, I guess, with what has been said regarding the response is the idea of being more targeted, and this is exactly what Section 301 did not do, and this is exactly what the Chinese are trying to do, what Beijing is trying to do, to target better its industrial policy to sectors that have a strong geo-strategy spillover. And in some ways, the reaction from the partners of Beijing should be similar, I guess more defensive, in the way we prevent Chinese distortions from spilling over into our markets. And that can be either through sectorial targeted restriction on imports or tariffs based on the distortion of the subsidies, so to speak, that Beijing and the public sector in China provide to those sectors.

And maybe to relate to the topic of Little Giants very quickly, we saw the shift of the KPIs that the local governments were using to select those SMEs away from commercial indicators and more towards either the substitution versus foreign inputs or the capacity to conquer technologically-sensitive new technology, such as semiconductors or potentially other types of technologies, such as quantum or even solar panel sometimes. And this is the idea from Beijing of better targeting the effort, indeed because they know they have less budget and less resources in the long run to invest and to lose in those efforts as they did in the past.

DR. HANSON: Very sorry. On the derisking part, I would distinguish between geopolitical risk, in which we're worried about China acquiring a technology that would make it more of a direct national security threat to us, and technological risk, in which China acquires technological capacity in particular sectors that impedes our ability to improve our standard of living.

On geopolitical risk, taking on aerospace, keeping that technology out of China's hands, makes a lot of sense. On the technological risk, keeping chips out of China's hands, to the extent possible, makes a lot of sense. But the other very important domain that touches on both is what to do about AI, and that we can't keep out of China's hands. China, as a surveillance state, is an enormous market for providers of AI within its country. What we want to do is keep China developing AI within its own closed system. That will make it less good at what it does. And we're seeing that separation of AI creation, those AI ecosystems. The U.S. has an open source model. People get together on GitHub and they create code together, and it makes this very organic process. China is progressively pulling out of that. So that's an environment in which it's not about tariffs, it's about what we do to create two different technology ecosystems that helps keep China isolated and, therefore, less competitive.

VICE CHAIR PRICE: Thank you all.

COMMISSIONER GLAS: Thank you. Commissioner Miller.

COMMISSIONER MILLER: Thank you all for your testimony today. Some of my fellow commissioners have been focusing on 301 and asking for your assessment, is it a good idea or bad idea. I'd like you, for a moment, to forget whether it's a good idea or a bad idea and picture the world, the end of 2026, with the decision already having been made to revoke PNTR on China and to perhaps double or triple tariffs as they are in their current form. How does the world look like at that point? How are supply chains changing, and what is going through the party's, what are the new policy priorities of the party to avoid the fallout of that kind of political decision if it has been made?

DR. HANSON: We start macro and go micro. So massive price shock means that, all of a sudden, there's a lot of stuff that China just can't export to the United States. What does it do?

For lessons of what might happen, think about what happened in Hong Kong, which had economic structure in the early 1980s not that different from where kind of China is, not so much now, maybe ten years ago. China jumps on to the world scene, blows Hong Kong's existing model out of the water. What does Hong Kong do? It gets into the business of selling Chinese goods abroad. If we make it hard for China to export labor-intensive manufactured goods to us via 60-percent tariffs, what is China going to do? It's going to develop an apparatus for exporting Chinese technology and Chinese capital and Chinese skills through other means, and that means very strong incentives for large-scale foreign direct investment throughout the Global South.

Controlling that via tariffs is hard. We can do it with Mexico because we have a free trade agreement with Mexico. Doing it with countries with which we don't have a free trade agreement is much harder. It creates an incentive for a coupling of China and India. That economic coupling just hasn't happened yet. That would really reinforce China being a source of the capital and technology to help India finally become a manufacturing powerhouse.

MR. WOLFE: Yes. I mean, I would agree with that assessment that China's share of intermediate goods in the global export market would increase dramatically because final assembly would just move offshore. The impact on the U.S. economy would be negative, higher inflation, lower growth, as a result. I think the impact on the global economy from this kind of fracturing of the production cycle would be lower productivity overall, more frequent supply shocks, so higher inflation, as well.

MR. CHIMITS: First, I want to echo what my co-panelists just said. We will all be much poorer overall and very significantly if the financial system has not completely cracked by then. One point, though to emphasize is that it's most likely, everything else being equal, China will get even more poorer than an advanced economy would. China has a more stringent need for foreign inputs directly as a product in itself but mostly as a technology and know-how. And on top of that, China has a gigantic need in foreign demand and for which it has no substitution than the U.S. and Europe, a bit less so but also Europe being important.

Now, if we factor in that equation, the reaction of third country, things might get more complicated and, largely, because most of the rest of the world would likely not follow the United States in those actions, meaning that you would get value chains from those countries more entwined with China than the American ones once the tariffs are in place, which might be very likely or which is very likely to be, in the long run, detrimental to both the American economy but also the American geopolitical standing.

And that would be, overall, I think, also maybe conclusion derived from the case study of the Section 301 is that very few partners have jumped on board. Indeed, for many countries, many partners, speaking from Europe in particular, this has been largely perceived as only erratic behaviors from the United States in many ways. I'm not saying it is. I'm saying the way it has been perceived. And explaining, and you still have, the Americans still have a lot of explaining to do regarding what exactly is the problem with China. If the problem is China being more powerful as an economy, then the rest of the world is likely not going to follow through. Indeed, if there is an issue with a non-liberal, if not sometime a bit totalitarian country or power, that has a clout on what you call foundational technology, the technology with a very strong economy, geopolitical spillovers, that might be something that more countries would be happy to join you fighting. Unfortunately, I think a lot of communication and after-sale services still have to be done on what are the real intentions of the United States in that regard.

COMMISSIONER GLAS: Thank you all for your testimony. Mr. Wolfe, I just wanted to follow up on some of your verbal testimony because I'm trying to reconcile it in my mind. There's a lot of data that comes out of China that indicates that they're sending us more stuff than our U.S. Customs is claiming receiving. Whose data is correct, and why is there an anomaly here?

MR. WOLFE: So in most instances, the U.S. data is much better than Chinese data. But in this particular instance, I think the Chinese data is more accurate.

COMMISSIONER GLAS: But what do we think is happening here? If anyone has any -- $80 billion we're not tracking, so I'm trying to figure out -- that's a lot, and how do we really assess what's happening in all aspects of their economy if we don't have accurate data about what is coming in?

MR. WOLFE: Yes. I don't think that the U.S. data -- the collection of the data has been flawed or there's some sort of manipulation happening with the U.S. data. I think what's happening is that you have a 25 to 40-percent tariff on these goods, and that's a strong incentive to avoid paying that tariff. And so there are ways to import goods into the U.S. and still not pay that tariff.

One example of how this could happen, which, obviously, this isn't in every instance, would be a container leaves from Shanghai, arrives in the port of Los Angeles, but it gets put onto a bonded truck, and so U.S. Customs doesn't record that as an import into the U.S., but China would have recorded it as an export to the U.S. That bonded truck then goes down to a factory or a warehouse in Mexico that's a bonded warehouse, so it isn't recorded as an export to Mexico or an import into Mexico. And then, from there, individual shipments can be taken out of the warehouse and shipped to the U.S. under de minimis shipping rules and so, again, would not be recorded in the U.S. data.

Now, that doesn't work for all of the tariff product categories, but it does work for some. And there are businesses that have been set up in Mexico to facilitate that, and I think that's one way that helps to explain this discrepancy that's emerged since 2018 in the data.

COMMISSIONER GLAS: So just as a quick follow up to that, we focused the first couple of panels, there was a lot of discussion about the consumer products area, a key dominant sector in the Chinese economy and has been for a long time. But, Dr. Hanson, you were noting they're getting out of that business and moving on to high tech. There's something not right here. We just heard various panels about China's continued dominance in these kinds of products, yet you're saying they're kind of phasing out, and I'm reading articles and our commission has done a lot of reports about their infrastructure development in central China into the western portion of China, their high level of unemployment amongst their youth, they need these labor-intensive sectors. Are we just sort of saying, hey, they decided there's winners and losers here? Because I guess I'm not seeing China as sort of an economy that has five winners and they've decided to get out of certain other labor-intensive industries entirely.

DR. HANSON: No. What I would emphasize is that the increased Chinese footprint in those labor-intensive sectors kind of hit its peak 15 years ago, and the change since then hasn't been much. Now, where China has increased its footprint has been outside of those sectors primarily in more high-tech stuff.

Now, as you mention, as China moves into high-tech stuff, that makes it more expensive to do that in Shenzhen, it makes it more expensive to do it in Shanghai. So you've got an option. You can go to Vietnam, which Chinese firms have done. You can also go into interior China, which is what Chinese companies are doing. And that's a movement we've seen very strongly since 2018.

Exports, as well as we can measure them, from interior China grew twice as fast from 2018 until 2022 when compared to what was happening on the coast. So what does that mean? That part of China is getting out of that labor-intensive stuff, but another part of China is getting in.

COMMISSIONER GLAS: Thank you for clarifying that. Commissioner Friedberg.

COMMISSIONER FRIEDBERG: Thank you very much. Mr. Wolfe, both you and Professor Hanson, if I understand you correctly, are describing a situation in which China is going to try to push even more manufactured goods out into the world in order to sustain its growth. It seems like they have only a limited number of options here. One would be to increase that export of manufactured goods to advanced industrial countries, to sell yet more to us and to others in our category. Number two would be to increase the sale of those goods to the Global South. And if they can't do either of those things, the third option it would seem would be to increase their own domestic consumption.

So is that a correct way of understanding the problem, first; and if it is, what could the United States and other developed countries do to prevent yet more of these products being dumped into our economies, and, in particular, what more could we do that does not involve protection?

MR. WOLFE: Well, I think, from China's perspective, it's not exactly what they say that they are trying to do. From China's perspective, they think that they have found a way to hold the line on the manufacturing sector and keep the manufacturing sector share of GDP relatively steady but do that by expanding its own domestic demand.

Now, in terms of economic theory, this just won't work, that, if they try to do it with domestic demand, that, over time, that the economy will shift towards services. And so it really depends on what the control variable is for economic policymakers. If the control variable is economic growth or the labor market and they're targeting a certain level of employment, then they will have to give up on holding the manufacturing share steady, and then they could allow their economies to grow or domestic demand to grow and absorb kind of the manufacturing the production side, which shrink the GDP but overall GDP would expand through those channels.

Now, I think the problem is that the control variable, at least until there's a big labor market problem, will be the manufacturing share. And the only way that they're going to be able to do that is through exports, and so that's going to impact the U.S., developed markets, and developing economies.

I think you do see broad agreement from developing economies and developed that this isn't going to work for them, and they do want to push back. And I think the coordination in a way that doesn't involve tariff orders but maybe product standards or other kind of non-tariff measures to agree to limit Chinese imports into not just particular markets but the global market would be much more effective or across a larger share of the global economy.

DR. HANSON: I draw a distinction between what China might want to do and what it's capable of doing. Go back and look at the China surge into labor-intensive manufacturing in the 90s and 2000s. China created all of these industry towns. We had the town that made disposable lighters, a town that made children's bicycle, a town that made socks, and go down the list. And that process of firms learning from each other, developing expertise, feeding off each other, is reminiscent of the industrialization of the United States. Dalton, Georgia became the carpet manufacturing center of the country; Martinsville, Virginia, rightly or not, billed itself as the sweatshirt capital of the country; Hickory, North Carolina in furniture. That specialization in China did not come out of a government plan. It came from organic firm growth.

Now, the government is trying to say this is going to be our center of robotics manufacturing, this is where we're going to do this generation of semiconductors. And it hasn't -- it's been able to pick off industries here and there, but it hasn't been able to regenerate that organic success that China had before.

So what it wants and what it gets I view as different things.

COMMISSIONER FRIEDBERG: Dr. Wolfe, back to you. What does it mean to say that their policies will not succeed? You said they won't succeed, but they won't fail right away, so what are we talking?

MR. WOLFE: Well, they won't succeed to hit the objectives that Xi Jinping has set for the economy, which would require, roughly, four-and-a-half percent growth per annum in the next decade or so. I think that it will also fail in the sense that it won't create enough jobs for China over the next decade. Even though the labor force is shrinking, the shift from a construction-driven economy and a service-driven economy to a manufacturing-driven economy will inevitably result in net job losses over a period of time if they were successful in pushing in that direction. And so, in that sense, I think it will be a domestic failure, as well, and an international failure in the sense that the rest of the global economy is unable or unwilling to absorb the type of increase that China would need to hits its GDP growth targets.

COMMISSIONER FRIEDBERG: So slower growth, yes?

MR. WOLFE: Yes, much slower growth.

COMMISSIONER FRIEDBERG: Higher unemployment.

MR. WOLFE: Higher unemployment, slower growth.

COMMISSIONER FRIEDBERG: But, potentially, making progress in some of these selected emerging technologies?

MR. WOLFE: Yes. I mean, I do think there are -- it's difficult to believe that China will succeed across the board or across all of these technologies but, in some areas, obviously, has already succeeded. In other areas, it's clearly in the process of succeeding; and in other sectors, it's falling further behind.

COMMISSIONER GLAS: Chairwoman Cleveland.

CHAIRMAN CLEVELAND: Thank you. I have a lot of questions. Mr. Chimits, you said in your opening statement that this certification process, this sports or Special Olympics approach to Little Giants and the entangling of state-owned enterprises with -- our preference is we usually refer to non-state because they're not entirely not subsidized, but this entanglement is making it harder to track rerouting and some of the other issues we've raised today and that you and others are trying to disentangle that to improve an understanding of the level of support that's offered to Chinese enterprises.

Could you elaborate on that? You said that you would be willing to do so in a question, so here it is.

MR. CHIMITS: So to elaborate, we do not necessarily so much disentangle the two than acknowledge that it's no longer possible to disentangle the two. And we try to establish a new way to identify the Chinese industrial political efforts and to propose a response to prevent the spillovers of those distortions on our economy and on our interests.

On the first, to identify, indeed, the idea is to draw the focus on subsidies in itself as a direct transfer from a public entity, a public body, to a commercial entity because when you have all your players in your economy that are trying to internalize the preference of the Party-state, it's harder to know who exactly is transacting at commercial price and who is trying to support industrial policy. Typically, if tomorrow a firm in China provides inputs to a Little Giant SME in biotechnology, if that price of that input is well below market price, is it a commercial move or is it a politically-motivated move? It's extremely hard to know when you're confronted with the blurring of the boundaries between the state and the commercial entities and when you're confronted with a whole-of-nation approach, as Beijing is trying to develop for its techno-industrial ambition.

So the favored approach that some are trying to establish is, first, to look at the intention and that advantage we have is that we are confronted with a Communist Leninist party that produces an awful lot of speeches and official language; and, hence, we can track by analyzing this language the distribution and the evolution of the industrial priorities of Beijing and then look at the break in trends on the market regarding either the price of the inputs of firms in the sector or the performance of those firms. You have had extremely interesting paper by Ms. Kalouptsidi on the shipbuilding industry, trying to reconstruct the actual policy support based on the break in trends on the shipbuilding industry. The shipbuilding industry is a more -- is an easy industry to conceptualize because you only have a few players and a few products. So I'm not saying this should be the only way forward, but this would be an interesting way forward.

The OECD, for instance, in parallel has developed interesting methodology to identify below-market capital, below-market debt, or below-market equity to try to identify where Chinese support has been flowing and how that resonates in international market. It has already covered 14 different sectors in its latest report, and what it finds is that, contrary to most advanced economy, on average, in those sectors, Chinese firms have received, roughly, five percent of revenue of state support, whereas OECD countries, on average, usually have received around 0.5 to 1 percent of revenue of support. That might look like a small difference. If you put that in a profit perspective and that you assume that most sectors have been five and ten percent of margin of profit, that's your entire profit that goes through state support.

And then on the intervention side, the EU, for instance -- the European Union, has refined its trade defense instrument to apply a non-market economy type of response to sectors where it has identified pervasive state support by the PRC. And this has already been applied in multiple sectors over the past five years and it has been de facto recognized as WTO-compatible by the WTO, not officially but because China has literally dropped its case in order to prevent the publication of the report that was constitutive of the case against those new European trade defense instruments.

CHAIRMAN CLEVELAND: Thank you very much. Commissioner Glas, do we have time for another question or are we going to do another round?

COMMISSIONER GLAS: Yes. Go ahead, Commissioner Cleveland.

CHAIRMAN CLEVELAND: I'm not sure whether it was Dr. Hanson or Wolfe who said that, as we look ahead, there will be an emphasis on doing one thing well. And I'm curious about that, Mr. Wolfe, in the context of your observations of -- I think you said in your oral testimony that the hukou system and land markets could help the economy pivot. I'm curious how, and then I'm interested in your assessment of -- each of your assessments of how each of, how your perception of strategy will have an impact on local debt because I continue to think that that's the piece of the puzzle that makes Xi's political ambitions, puts Xi's political ambitions at risk.

So, Mr. Wolfe, hukou and land markets, how could that help? And then if you could each speak to the impact of local debt, whether it's selection of Little Giants or -- yes.

MR. WOLFE: So I think factor market reforms, including the hukou system and land market reforms, are part of the five-year plan but not, like, the top level targets. But those would probably be the things that could deliver the most productivity growth for China for the medium term and could help to boost Chinese growth going forward.

In some ways, though, especially hukou reform, combined with rural land market reforms, could actually help China to gain more global export share and could contribute to its inflationary pressure in the short run. In the sense that you still have about 24 percent of China's employment in the agricultural sector, whereas when Japan and Korea were at China's current level of development, that was down to about 14 percent.

And so if these factor market reforms were pushed through in a rather abrupt way, you could see another cohort of labor leaving agriculture that would have to be absorbed by the manufacturing sector or services, and that would put downward pressure on wages and make Chinese goods more competitive internationally and help China to hold on to some of those lower-end manufacturing products going forward.

And then on the local government debt issue, I think that we're nearing the point that this becomes a constraint on industrial policy, but we're not quite there. So China has something similar to, like, a dramatic debt break in terms of its on-balance sheet debt as official government policy. And you see more and more cities and township levels across those debt thresholds where they're pushed into some sort of austerity program. So far this year, it's been reported that 14 provincial-level governments have crossed that threshold and been put into some sort of austerity program. And what that means in practice is that their infrastructure expansion plans have been curtailed and will be curtailed this year, and so we're seeing that impact come through; but we're not yet seeing the point where industrial subsidies and this kind of competition to lure manufacturers through local government subsidies has been impaired yet.

But the more intense the debt pressure gets or the more intense the austerity pressure from the central government, coupled with the central government's push for a unified national market, which would have to remove some of those protectionist measures at the local level that are used to lure companies to those jurisdictions, that could impede some of the industrial subsidies, the local subsidies, which are much larger than the central government subsidies.

CHAIRMAN CLEVELAND: What I'm hearing in that, the challenges, and, again, I'd like others to speak to it, how they push forward with this plan to target these seven sectors if local governments aren't in the position to subsidize support in the way that they have these enterprises. So, yes, I'm not sure I'm quite understanding.

MR. WOLFE: Yes, I think that it will be complicated. I think what the central government wants and what the central government can get might be different over the next few years. Well, the seven targeted sectors have been drawn up by the central government, and those proliferate down to the local level through, you know, various planning apparatus. Most of the implementation of this does happen at the local level. If the local level doesn't have the resources to do it and the central government is either unable or also doesn't have the resources to coordinate it, then they would find it more difficult to support those strategic sectors going forward.

COMMISSIONER GLAS: We have an additional question from Commissioner Wessel.

(Pause.)

CHAIRMAN CLEVELAND: I don't know about the public, but I've lost sound.

COMMISSIONER WESSEL: I did not have mine on. My apologies. I was asking about trade defense mechanisms.

CHAIRMAN CLEVELAND: You're very animated.

COMMISSIONER WESSEL: I'm always animated. And I don't see the aggressive use of trade defense mechanisms by the EU, and I was questioning what you were referring to. I know they've talked about saying they will use them, but where have they used them that you're referring to?

MR. CHIMITS: So it depends on what benchmark you're using to qualify the intensiveness of the use of those --

COMMISSIONER WESSEL: I use the U.S. measure.

MR. CHIMITS: All right. If you benchmark it on the American tariffs, indeed, it's much more marginal and the increase remains rather marginal. If you benchmark it on the level of extra trade defense-related tariffs that are being applied to the bilateral flows of trade, by various estimates, this is an increase, this is a doubling of the flows of tariffs that have been impacted by EU trade defense instruments in the bilateral relation between EU and China over the past five years.

COMMISSIONER WESSEL: And what are you referring to? What industries -- and you can provide this later, but what are you specifically referring to?

MR. CHIMITS: At the moment, I was thinking about the aggregate numbers. I wasn't --

COMMISSIONER WESSEL: And for the record, it's fine. I'm just, I have not seen --

MR. CHIMITS: The best illustration we have at the moment are, obviously, the one investigation on electric vehicle that is, I would say, the flagship investigation --

COMMISSIONER WESSEL: But that's an investigation, not yet utilization.

MR. CHIMITS: Correct. On the aggregate number, steel and aluminum has been largely affected, in part as a response to prevent --

COMMISSIONER WESSEL: 232 and, yes --

MR. CHIMITS: Exactly. But that was also done under TDIs in some respect, not only under safeguard. And those TDIs, in terms of substance of the distortion they tackled, have been profoundly reviewed by the Europeans in order to tackle those much more sophisticated distortion that are being implemented in Xi Jinping's China that we have reviewed and that the traditional instruments usually struggle to tackle.

And the other dimension and that relates to a discussion you've been having in a previous panel when we entered the room is transnational distortion. And we have seen European trade defense instrument being used against products coming from Egypt, Indonesia, and Morocco. The sectors are aluminum trade and cable fibers, if my memory is correct, for subsidies that were actually provided in China to Chinese firms for production in those regions and, even more so, in those regions in Belt and Road-supported industrial zones, both for the subsidy at home but also for the absence of taxation and the preferential treatment in those zones that contradict the principles of the WTO.

COMMISSIONER WESSEL: Great. Thank you. And, Mr. Hanson, it's been a long time since you've been here, so welcome back. I was here when you appeared last time.

Just a quick comment. You talked about industries where we should welcome Chinese overcapacity or willingness to support industries, and you mentioned, for example, high-capacity batteries. I would view that as a national security risk, and I think if you realize recently or you saw that the Department of Defense acted to restrict the use of Chinese-produced high-capacity batteries on Camp Lejeune's supporting electric grid because they view them as pre-placed munitions on the U.S. grid. So, you know, you have to look deeper as to where those threats might be. And, again, we are analyzing that all the time.

DR. HANSON: I was being perhaps purposely flippant to make a point. But the broader principle I would emphasize is that there's a number of areas in which we're trying to figure out which direction technology should go. Right now, lithium-ion batteries are the technology in the room. We've got some other technologies that are going to come along the way. We're going to make a bunch of mistakes in figuring out where we should go.

There's going to be some of these areas, not saying batteries should be the primary one, where we can let China make some of those mistakes and they're, in effect, subsidizing our R&D efforts.

COMMISSIONER WESSEL: I understand from, you know, Dr. Summers' view that, you know, supporting the U.S. consumer is an economist's dream. I think it's a policymaker's deep concern long term because it trends to price us out of a market and potentially destroy capacity, and I think that's what happened here in solar and other areas. But that's for further debate, hopefully, at your next visit, which won't be as long. Thank you.

COMMISSIONER GLAS: Do any commissioners have any further questions? Commissioner Cleveland.

CHAIRMAN CLEVELAND: A quick question. It's been a long day. Dr. Hanson, you referenced in response to a question by Commissioner Sims politicization of higher education. I think you said something to the effect of there's no longer a desire to be the best, rather there's more concern about the party cell, whether it's the dean or something else, their approval and the prospects of promotion, and that that was true in industry, as well. We've certainly looked at that in the past.

I'm curious how that squares -- that concept of higher education squares with what you said in your oral and written testimony about improvements in education and how that will be a factor in growth, if it is as politicized and it's no longer, you know --

DR. HANSON: So to say it's politicized doesn't mean it doesn't generate a significant economic impact for China. It means that they're spending that money on higher education in a way that isn't all that efficient, so they're diverting resources from just trying to be the best to trying to accomplish these other political objectives, too.

They aren't only making mistakes in terms of politicizing higher education. They also have a rewards system that's kind of brute force: you reward people for the number of academic publications they generate. When you do that, you're going to get some schlocky work. China is not number one in the fraction of its academic articles that are retracted per a thousand of articles it produces, it's number three. It's behind Saudi Arabia and Russia. In terms of the raw number of articles it has to retract, it's way ahead.

So it's not that China is not going to produce great insights, great faculty, good programs. It's just that the ROI on its dollar -- on its investment in higher education is much lower than it could be.

CHAIRMAN CLEVELAND: Thank you.

COMMISSIONER GLAS: Thank you. Thank you so much to the panelists. In closing, thank you again to all of our witnesses for your excellent testimonies today. You can find those testimonies, as well as a recording of the hearing, on our website.

I'd also like to express my deep appreciation to Commissioner Cleveland and the commission staff, especially Aubrey and Daniel. I'd like to note the commission's next hearing will take place on Friday, March 21st. That hearing is titled China's Evolving Counter-Intervention Capabilities and Implications for the U.S. and Indo-Pacific Allies and Partners.

Finally, on the same note as Commissioner Cleveland, I want to thank Dan Peck for his last day and all his contributions to the commission for the many, many years. You have made a lasting impact on the commission, and we wish you all the best.

And with that, we are adjourned. Thank you.

(Whereupon, the above entitled matter went off the record at 3:55 p.m.)

U.S.-China Economic and Security Review Commission
Questions for the Record: Consumer Product Safety Commission (CPSC)

1. **The CPSC's *FY 2023 Agency Financial Report* states that "CPSC staff screened more than 66,000 products at our borders for potential violations, of which more than 17,000 were from de minimis shipments, which are shipments costing $800 or less" (p.iv). Please describe in detail what "screen" means in this context.**

   The Consumer Product Safety Commission (CPSC) uses the term "screen" when referring to products that have been targeted at importation and physically examined, often using sophisticated tools, to determine compliance with CPSC requirements. The results of these screenings are recorded by the examining investigator in CPSC's Risk Assessment Methodology (RAM) Exam Logbook.

   a. **How many de minimis packages have been seized and destroyed last year for non-compliance with U.S. consumer product safety laws? Where did these seizures occur? What were the products?**

      While CPSC evaluates and makes recommendations to U.S. Customs and Border Protection (CBP) on whether a given shipment should be seized, CBP ultimately determines the final disposition of the shipment. In fiscal year (FY) 2023, CPSC recommended seizure of 387 de minimis shipments, containing 2908 products and 223,263 individual units. CPSC requested an action other than seizure (such as exportation or allowing reconditioning of the product to bring it into compliance) for 32 additional de minimis shipments, representing 40 products and 31,877 individual units. These interdictions were made across all ports of entry where CPSC has co-located investigators. The products similarly ranged widely across those that CPSC regulates.

   b. **How many non-de minimis packages have been seized and destroyed last year for non-compliance with U.S. consumer product safety laws? Where did these seizures occur? What were the products?**

      While CPSC evaluates and makes recommendations to CBP on whether a given shipment should be seized, CBP ultimately determines the final disposition of the shipment. In FY 2023, CPSC recommended seizure of 863 non de minimis shipments, accounting for 5,114 products and 6,957,283 individual units. CPSC requested action other than seizure for 356 additional non de minimis shipments, representing 1,497 products, and 7,499,994 individual units. These interdictions were made across all ports of entry where CPSC has co-located investigators. The products similarly ranged from across all those that CPSC regulates.

c. **How many de minimis packages/e-commerce shipments have been tested at labs for non-compliance with U.S. regulations? What are the products of greatest risk?**

In FY 2023, CPSC staff evaluated 447 de minimis shipments for non-compliance, representing 3,006 products and 346,017 individual units. These samples were either delivered to the CPSC lab for further testing or were evaluated by CPSC headquarters staff to determine violations of consumer safety laws. CPSC considers those products that cause an immediate hazard of death or injury (such as fire or fall risks) or those that might cause chronic illness or injury (such as chemical exposure) to be of the highest risk to consumers.

2. **Please provide a list of factors the CPSC uses to prioritize imports in its screening process. What features of an import or importer does the CPSC consider to be the most critical in determining an import's level of risk? What weight are these different factors given in the process of selecting imports for screening?**

CPSC's Office of Import Surveillance incorporates a wide variety of factors into its targeting and risk assessment. These may include specific information related to the entity importing or facilitating the shipment, information related to the product itself, or CPSC-maintained data on previous violations. For products considered to be of the highest risk category, CPSC staff works with CBP's Commercial Targeting and Analysis Center to target entities that have a higher likelihood of importing noncompliant products into the United States, for instance because they have previously violated or because they have not previously imported CPSC-regulated products.

3. **What categories of products sold by 3rd party sellers on e-commerce platforms pose the highest risks to U.S. consumers? How does the CPSC assess that risk?**

CPSC's eSafe team presumes that all products for which CPSC has conducted a recall should be removed from commerce, including from e-commerce platforms. The eSafe team does conduct an assessment to determine if a recalled or banned product can be effectively located on e-commerce platforms. CPSC does not analyze levels of product hazard based on the seller or method of sale. Instead, staff assess each potential substantial product hazard and each potential regulatory violation based on the information CPSC staff receives, which includes information about the number of incidents, the number of injuries, and the number of deaths (if any) as well as a technical analysis of how consumers interact with the product and the nature of the risk that interaction poses.

4. **In the past ten years, how many cases involving allegations of product safety law violations has the CPSC referred to the Department of Justice?**

   Since 2014, CPSC has referred 16 cases to the Department of Justice for violations of the civil provisions of statutes overseen by the Consumer Product Safety Commission.

5. **What is the difficulty the CPSC and other agencies face in a de minimis environment to hold importers accountable if their products fail to meet U.S. consumer product safety laws?**

   Products qualify for de minimis treatment if the total value of the items taken together shipped by one person or entity on one day is $800 or less. For CPSC, the issue is that companies sending goods under the de minimis threshold do not need to file as much documentation about their shipments as is required for higher-value shipments. The limited documentation, in turn, does not allow CPSC to effectively use its RAM, referenced above, to determine which shipments pose the most risk and on which to focus its limited resources. Additionally, these shipments often enter the country at locations where CPSC may lack a significant presence.

   CPSC staff expects that the planned eFiling program will address some of the information gap that presently exists for products shipped under the de minimis exception. After completion of the ongoing beta pilot and future publication of a final rule, importers would be required to provide specific data from their certificates of compliance to CPSC and CBP at the time a product is imported. This data will allow the agency to use the information as part of its risk assessment.

6. **From initial detection of the issue to issuing a formal recall, please outline each step of the recall process. When and how are importers and consumers engaged? What happens if the manufacturer and CPSC cannot agree on the terms of a voluntary recall? How frequently does the CPSC issue mandatory recalls, and how much longer do mandatory recalls take?**

   CPSC staff initiates investigations of potentially dangerous products based on information from a variety of sources, including incident reports, reports from firms, whistleblower reports, news reports, and online and port surveillance of products. CPSC staff works with manufacturers, importers, distributors, and retailers to achieve voluntary recalls when staff has determined that a product hazard warrants a recall. Compliance staff will frequently present investigative information, including technical analysis of the product, to cause firms to take voluntary corrective action. Thereafter, staff negotiates the remedy the firm will provide consumers (e.g., refund, repair) and the communications used in the recall. Consumers are engaged via those communications about the recall, which can include social media and direct outreach. Products that are recalled are considered illegal for further sale (absent an agreed-upon repair).

Obstacles include convincing firms that a recall is necessary and, if that fails, the resources CPSC and potentially the Department of Justice must use in suing a firm to seek a mandatory recall. The mandatory recall process can take years and involves administrative and/or federal court litigation. For these reasons CPSC staff works diligently to attempt to come to terms with the company involved on a timely voluntary recall that adequately protects the public.

One way CPSC can act to protect the public quickly if a company refuses to agree to a voluntary recall is to issue unilateral notice to the public about the dangers of a particular product. While not a recall with remedies from the responsible firm, this unilateral notice gets the word out about a dangerous product without having to wait potentially years for the resolution of a mandatory recall case.

7. **What are the impacts to U.S. consumers of unsafe, harmful, and non-compliant products imported to the United States? Please quantify these impacts where possible?**

CPSC estimates that deaths, injuries, and property damage from consumer product-related incidents cost the nation more than $1 trillion annually. According to a 2021 CPSC study[1], between 2018-2020, there was an annual average of 48,500 deaths and 34.37 million injuries associated with consumer products.

8. **Please describe the process for accrediting third-party testing laboratories located in China. What reviews or other controls does CPSC have in place for verifying the ongoing adherence of these labs with third-party testing standards?**

The requirements for CPSC third-party conformity assessment bodies are codified in the Code of Federal Regulations (CFR) at 16 CFR Part 1112. At a high level the third-party conformity assessment body must submit a completed Consumer Product Conformity Assessment Body Registration Form (CPSC Form 223). It must also attest that it has read and understands and agrees to the regulations. In addition to CPSC Form 223 they must submit documentation of their accreditation certificate indicating they are accredited to ISO/IEC 17025 and the accreditation body is a signatory to the International Laboratory Accreditation Cooperation-Mutual Recognition Arrangement (ILAC-MRA). The third-party conformity assessment body's accreditation must include a statement of scope that clearly identifies each CPSC rule and/or test method for which CPSC acceptance is sought. There are

[1] https://www.cpsc.gov/content/Consumer-Product-Related-Injuries-and-Deaths-in-the-United-States

additional requirements if the conformity assessment body is applying as a firewalled conformity assessment body or Governmental conformity assessment body.

Third party conformity assessment bodies are subjected to auditing no less than every two years. The audit requirements for a CPSC third party conformity assessment body are located in subpart C of 16 CFR Part 1112.

Response from Teresa Murray to U.S.-China Economic and Security Review Commission request for follow-up to March 1, 2024 in-person testimony. March 28, 2024

Question for the record: *In addition to children's toys, are there other types or categories of products imported from China that present elevated safety hazards or risks to U.S. consumers? What is the nature of the risks associated with these products, and how do these risks impact consumers?*

Response:
Yes, there are many types or categories of products imported from China besides children's toys that present elevated safety hazards to U.S. consumers.

In addition, unsafe/hazardous products manufactured in China often fall outside of CPSC enforcement if the seller or importer is also in China and won't cooperate with a recall or respond to CPSC queries.

The problem comes down simply to this: Many manufacturers in China don't adhere to safety standards required for many consumer products that are sold in the United States. Consumers have little transparency into where products come from and little insight into the regulatory process that allows goods to be purchased that don't meet U.S. safety standards, even products we plug into electrical outlets or use to care for our infants.

Out of the roughly 15,000 products overseen by the CPSC, about 250 types of products – such as art materials, bicycles, clothing, garage door openers and medication bottles – must meet specific mandatory safety standards, which differ from product to product. For example, these include adult bicycle helmets that must meet impact requirements and any product with a power cord that must meet wire gauge requirements.

There are also voluntary safety standards for all sorts of products, which the CPSC expects compliance with. The three most widely relied on:

- Underwriters Laboratories (UL) standards for a range of products, including electrical products, lawn and garden equipment, appliances, batteries, lithium ion battery packs, handheld power tools, and even products as specific as fire extinguishers and hospital nurse call buttons.

- American National Standards Institute (ANSI) standards for a range of products, including furnaces, gas appliances, all-terrain vehicles, coffee makers, ladders, light bulbs, etc.

- ASTM International standards for a range of products, including bicycles, bunk beds, candles, ski equipment, playground equipment, liquid laundry packets, etc.

The CPSC says: “These standards are not endorsed by the CPSC; however, failure to meet a voluntary safety standard could lead to a substantial product hazard determination by the Commission and result in a recall.”

As discussed previously in my testimony, the list of products with required standards also includes all categories of children’s products – meaning those “designed or intended primarily” for children 12 or younger. This covers toys, clothing and other items. They must meet standards for issues such as lead and phthalates, small parts and warning labels. The standards include third-party testing and certification.

Examples of products manufactured in China that are *not* toys or any other children's product that have presented safety risks in recent months include:

- **Dehumidifers**
  The CPSC in August 2023 issued an urgent warning regarding more than 4 million dehumidifiers manufactured in China because the CPSC determined "they can overheat, smoke, and catch fire, which can lead to serious injury or death." The dehumidifiers have been linked to four deaths, 450 fires and $19 million in property damage, the CPSC said. In addition, there were more than 2,000 complaints of the recalled dehumidifiers overheating.

  The dehumidifiers were manufactured by Gree Electric Appliances, Inc. of Zhuhai, China, and marketed under multiple brand names, including Danby, De'Longhi, Fedders, Fellini, Frigidaire, GE, Gree, Kenmore, Norpole, Premiere, Seabreeze, SoleusAir and SuperClima.

  Gree issued multiple recalls for various models over the years; the products at issue were sold starting in 2005 at well known retailers including Home Depot, Lowe's, Menards, Sam's Club, Sears and Walmart. Ultimately, the company paid a $15.45 million civil penalty and two top executives were indicted in 2019 and convicted in 2023 for knowing their products were defective and could catch fire, and knowing they were required to report the information and intentionally didn't report it. The deaths all involved adults and occurred in house fires believed to have been caused by the Gree dehumidifiers. One death occurred in 2016 in Ohio. Another death occurred in 2022 in Iowa. Two more deaths occurred in 2022 in Missouri.

- **Extension cords**
  Just this month, in March 2024, the CPSC issued a warning about Faddare 16.4-Foot extension cords "because they have undersized

wiring, posing shock and fire hazards. The extension cords do not comply with the wire gauge requirements of the mandatory federal safety standard for power cords." The seller is Great Effort of China, "but the firm has not responded to requests for a recall," the CPSC said. The extension cords were sold exclusively on Amazon, which agreed to notify people who bought these through Amazon. This is not the same thing as a marketwide recall, however.

- **Bicycle helmets**
  Bell Sports recalled about 15,000 Giro Merit bicycle helmets in June 2023 because they do not comply with U.S. safety standards for bicycle helmets (16 CFR § 1203.17 - Impact attenuation test.) The helmets can fail to adequately protect a rider in the event of a crash, which poses the risk of a head injury. The high-end helmets (retail about $220) were manufactured in China.

  In other cases involving violative bike helmets, the manufacturers won't cooperate with a recall. For example, in September 2023, the CPSC issued a warning for consumers to immediately stop using Vera Natura adult bicycle helmets "because they can fail to protect riders in the event of a crash, posing a risk of head injury. The helmets do not comply with the positional stability, dynamic strength of retention system, or labeling and certification requirements of the mandatory federal safety standard for bicycle helmets."
  The CPSC was able to contact the seller, Tengingyue of China, but the seller didn't agree to recall these helmets or offer a refund or replacement to consumers. The bike helmets were sold online at walmart.com for about $11. The CPSC urged customers to stop using the helmets, cut the straps and throw the helmets away immediately.

In many other cases involving bike helmets manufactured in China, they're flagged by the CPSC for violating 16 CFR 1203.17 and the CPSC wants the companies to recall them, but the CPSC has no regulatory power because the companies are in China and haven't responded to CPSC requests.

In one of many cases from 2023, YUNZHIWUHANDIANZISHANGWUYOUXIANGONGSI DB in Hong Shan Hu Bei, China, was asked in February 2023 to issue a recall for bicycle helmets but, as of March 29, 2024, there's no indication this has occurred.

- **Travel irons**
  In December 2023, Vornado recalled 1.75 million Steamfast Home & Away Travel Steam Irons following 74 reports of the power cord smoking, sparking, catching fire or overheating or showing other signs of defect. The travel irons were manufactured in China and imported by Vornado Air LLC, of Andover, Kansas. The company's previous recall in April 2023 involved about 317,000 Brookstone and Steamfast irons. It hasn't been publicly disclosed whether these violated a specific safety standard, but clearly something wasn't working as it should.

- **Children's play pens/play yards**
  In 2023, the CPSC flagged multiple playpens and play yards manufactured in China because they exceeded limits for phthalates or lead, both of which are highly toxic, particularly to children. Exposure can cause a range of issues, including, for phthalates: learning disabilities, autism, endocrine-disruptive diseases, asthma, type II diabetes, neurological and reproductive disorders and various forms of cancer; and for lead: damage to the brain and nervous system, learning and behavior problems, and hearing and speech problems and slowed growth and development.

- **Gas ranges**
  ZLINE recalled about 30,000 gas ranges in November 2023 because they emitted unsafe levels of carbon monoxide. Originally, about 28,000 were recalled in December 2022; that was expanded twice in 2023. They were manufactured in China and imported by ZLINE Kitchen and Bath, of Reno, Nev. It hasn't been publicly

disclosed whether these violated a specific safety standard, but clearly something wasn’t working as it should.

- **Air fryers**
  Cosari recalled about 2 million air fryers in February 2023 because they could overheat, posing the risk of fires or burns. Cosari received 205 complaints about the air fryers catching fire, burning, melting, overheating and smoking, including 10 involving injuries and 23 involving property damage. They were manufactured in China and imported by Atekcity Corporation, of Anaheim, Calif. It hasn’t been publicly disclosed whether these violated a specific safety standard, but clearly something wasn’t working as it should.

To the second part of your question: What is the nature of the risks associated with these products, and how do these risks impact consumers?
The risks cover a wide spectrum: The potential for minor injuries; major, life-changing injuries; illnesses; death and catastrophic property damage.

I cited a handful of examples above that posed the risk of head injuries, carbon monoxide poisoning, burns, fires, exposure to toxics, death and other damage to property besides just the product involved. I could have gone on with hundreds and hundreds of products from China flagged by the CPSC or recalled just since the beginning of 2023.

Thank you for inviting these comments.

Dan Harris, Partner
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Sinosure and its Support for Chinese Government Objectives

Sinosure is a vital instrument for the Chinese government in achieving its domestic and international economic goals. By offering various insurance products at heavily subsidized rates, Sinosure mitigates risks for Chinese businesses and financial institutions, promoting economic activity aligned with the Chinese government's priorities.

Many view Sinosure as an insurance company, which is how the Chinese government tries to sell it. But in my experience, that is just a small part of Sinosure.

The Chinese government is deliberately opaque about Sinosure and most of what I say below is based on my own experiences with Sinosure (I have been involved in close to 100 matters involving Sinosure), discussions with academics who have researched Sinosure, and current and former Sinosure employees. Neither I nor anyone with whom I have spoken about Sinosure claims to have complete certainly regarding hardly anything they say about Sinosure. This is due to the opaqueness, along with Sinosure constantly changing, and Sinosure actually being made up of regional Sinosures, which sometimes vary in their roles and their tactics.

Based on my experiences, there are no companies in China that export and are not covered by Sinosure. Based on conversations with Chinese companies, this insurance is essentially mandatory, and it is heavily subsidized, perhaps in some cases even free.

I also have in the last few years become convinced that the Chinese government uses Sinosure as an excuse to see into the inner workings of every export company in China.

Sinosure's computers are tied into the computers of Chinese exporting companies such that Sinosure knows when a purchaser is late with a payment and will often act on that late payment without even alerting the Chinese selling company that it will do so.

This gives Sinosure tremendous power. It can and does make collections decisions on behalf of Chinese companies and its decisions on how to proceed regarding a late payment often seem to have a greater connection to the political strength of the Chinese insured company, the desire to make life difficult for a particular industry sector of foreign companies, or local/national employment condition, than the best interests of the insured. I was involved in a matter where Sinosure paid around $5 million on a 100% invalid claim, without doing any investigation on the claim whatsoever. When I asked a Sinosure person why this had happened, this person, said, "I don't know, I'm guessing it's just because they are terrified about unemployment right now. This explanation made total sense to me.

Sinosure's Domestic Economic Objectives

Since Sinosure is the CCP, its economic objectives will be those of the CCP. Those typically include the following.

- **Growth and Stability:** Sinosure encourages exports by insuring receivables from foreign buyers, safeguarding Chinese businesses against payment defaults. This fosters export-oriented manufacturing, a key driver of China's economic growth.
- **Industrial Policy:** Sinosure can and does prioritize specific sectors deemed important by the government. By offering preferential insurance rates or coverage terms for these sectors, Sinosure can channel resources and investments towards industries the government seeks to develop, like high-tech or clean energy.

- **State-Owned Enterprises (SOEs):** Sinosure plays a crucial role in supporting SOEs, which are dominant players in many key industries. By providing them with both better and cheaper insurance for their domestic and overseas projects, Sinosure bolsters their financial health and creditworthiness, facilitating their access to capital and growth.

Sinosure's International Economic Objectives

- **Belt and Road Initiative (BRI):** Sinosure is a key pillar of the BRI, which is designed to expand China's global economic and political influence. Sinosure insures Chinese investments and loans associated with BRI projects, mitigating risks for Chinese companies venturing overseas. This encourages participation in BRI projects and facilitates the outflow of Chinese capital for strategic objectives.
- **Market Share and Influence:** By subsidizing Chinese exports and overseas investments, Sinosure strengthens China's position in the global market. Increased trade and investment flows generate economic benefits for China and bolster its standing as a major trading power.

Challenges for the United States

Sinosure's activities present several challenges for the United States:

- **Unfair Advantage:** Extensive government support through Sinosure distorts markets and gives Chinese companies an unfair advantage in competing with US firms. This could hinder US exports and limit market access for US businesses.
- **Geopolitical Competition:** The BRI, heavily backed by Sinosure, is a Chinese tool to expand its economic and political influence globally, potentially challenging US interests and alliances.

- **Debt Sustainability:** Sinosure's backing of risky loans and investments, particularly those associated with the BRI, raises concerns about potential debt burdens on recipient countries. It also leads to massive corruption and shaky and shady projects.

Potential US Responses to Sinosure

The US can address these challenges through various strategies:

- **Strengthening Export Promotion Agencies:** The US can bolster its own export credit agencies to better compete with Sinosure. This could involve offering competitive insurance rates, expanding coverage options, and streamlining application processes.
- **Promoting Fair Trade Practices:** The US can work with our allies to advocate for fair trade practices and challenge policies that distort markets in favor of Chinese companies. This could involve pursuing agreements to limit government subsidies and ensure a level playing field for competition.
- **Focusing on US Strengths:** The US can leverage its strengths in innovation, technology, and rule of law to attract foreign investment. This could involve promoting US infrastructure development projects as alternatives to BRI initiatives.
- **Investing in Alliances:** The US can strengthen its alliances with countries potentially vulnerable to Chinese debt or undue influence. This could involve offering development assistance and promoting alternative financing mechanisms.
- **Suing Sinosure/China:** The US and even private companies should consider suing Sinosure (and/or the Chinese government) in U.S. and world courts for illegal subsidies and unfair trade practices.

U.S.-China Economic and Security Review Commission
Questions for the Record: François Chimits

1. **Please provide 3-5 examples of Chinese Little Giants that exemplify the pyramid cultivation system. In these examples, please be specific about the origins of the company, including whether they are spun off of state-owned enterprises or other large non-state companies. Please also describe the support they received from local governments, including from government guidance funds or local government financing vehicles.**

NAME (CN)	NAME (EN)	BATCH
中科新松有限公司	Siasun Co., Ltd.	1
上海格拉曼国际消防装备有限公司	Shanghai Grumman International Fire Equipment Co., Ltd.	1
苏州绿的谐波传动科技股份有限公司	Leader Harmonious Drive Systems Co., Ltd.	1
埃夫特智能装备股份有限公司	Efort Intelligent Equipment Co., Ltd.	1
青岛宝佳自动化设备有限公司	Qingdao Baojia Automation Equipment Co., Ltd.	1
深圳众为兴技术股份有限公司	Adtech (Shenzhen) Technology Co., Ltd.	1
北京天智航医疗科技股份有限公司	Tinavi Medical Technologies Co., Ltd.	2
北京凌天智能装备集团股份有限公司	Beijing Topsky Intelligent Equipment Group Co., Ltd.	2
山西嘉世达机器人技术有限公司	Shanxi Jiashida Robot Technology Co., Ltd.	2
南京中电熊猫晶体科技有限公司	Nanjing China Electronics Panda Crystal Technology Corporation	2

Leaderdrive has received CNY 9.0 million in investment from government guidance funds (GGFs). In August 2020, a year after being recognized as a Little Giant, the firm listed on the Shanghai stock exchange (688017.SH) and raised CNY 1.06 billion in capital. The amount of government subsidies received by the firm has risen by 50 percent over 2019 levels. The company has grown very strongly since its selection as a Little Giant. The company's assets tripled between 2019 and 2021 and its revenue doubled between 2020 and 2021.

Efort received a total value of CNY 112.6 million of investments by GGFs. One year after being designated as a Little Giant in June 2019, Efort went public on the Shanghai stock exchange (688165.SH) in July 2020, raising CNY 823 million in capital. On its first day of trading on the STAR market, Efort's shares rose by almost five times the issuing price, and its market capitalization reached CNY16.2 billion.

But the firm's performance on the stock market has dramatically deteriorated since. As of December 20, 2022, its market capitalization was just CNY 4.2 billion. Efort's financial performance has gone from bad to worse. Net income fell from CNY -42.2 million in 2019 to CNY -193.4 million in 2021 and its receipt of government subsidies also decreased in 2020 and 2021. Nevertheless, R&D expenditure increased by 40 percent between 2020 and 2021.

The sixteen listed Robotics Little Giant firms have benefited from substantial direct and indirect state support over several years, both before and after their selection as Little Giants. These companies received government subsidies and investments from GGFs, and were granted hundreds of procurement contracts. The following estimates present the average annual support granted to each firm between 2016 and 2021 in key areas:

- Equity funding: CNY 37.5 million in below-market equity (9.4 percent of revenue), of which part would be derived from government guidance funds, worth approximately CNY 3.6 million each year (0.9 percent of revenue)
- Subsidies: CNY 18.9 million in direct subsidies (4.0 percent of revenue)
- Below-market debt: CNY 1.2 million in indirect subsidies (0.3 percent of revenue)

Taken together, this amounts to CNY 58 million in additional annual financing for each robotics Little Giant firm, or about 13.7 percent of average annual revenue. The greatest boost delivered to robotics Little Giants has been the increase in equity financing, linked to the high number of firms that went public following their nomination (see exhibit 23 below).

Exhibit 23: