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Ted C. Fishman
Author, ***China Inc.: How the Rise of the Next Superpower Challenges America and the World***

Hearing on
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Stanford University
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First, I want to commend the members of this commission, and its staff, for attaching high importance to the issue of technology transfer to China. You are certainly correct in regarding technology transfer as one the most crucial issues in our relations with China and in our economic futures. In reporting my book, China, Inc., How the Rise of the Next Superpower Challenges America and the World, I came to see the transfer of technology and other intellectual property to China as one of the most urgent problems in our economy. Without swift and forceful action to reverse the free—and by "free" I mean "no cost"--flow out of our knowledge economy into China, the United States will lose the heart of our economic strength and see a rapid diminution in our standard of living. I will come to some of the specifics of the argument further on. First, I would like to put my comments on technology transfer and intellectual property in context with a few general observations about China and the United States.

China now informs nearly every big question about America's future. Take your pick: the future of our financial system, the demands on our schools at every level, how we shop, how we make things, how we employ workers at home and around the world. Our national security, global prestige and persuasiveness are increasingly affected by China's new-found economic might and confidence and, more importantly, by how we see China's future prospects. Whatever China's weaknesses—and it has many—it is folly to not to acknowledge that its long-term prospects will most likely build on its considerable strengths, and that the country will go richer, stronger and far more influential over the coming decades. It is all but inevitable, for instance, that China will overtake the United States as the world's largest economy. Simple math makes the point. With five or six times the U.S. population, China need only provide its people with one fifth or one sixth the average income of Americans to have the largest economic footprint in the world. There is much talk lately about the value of China's currency, with some U.S. manufacturers suggesting that the yuan is 40 percent cheaper against the dollar than it ought to be. Should China take the single step of letting its currency float freely on the world market, the per capita incomes of the Chinese will increase from one-thirty-eighth of the U.S. average, to one-twenty-seventh. That is still low enough to keep China as a low-cost factory floor for the world, but it nonetheless offers an enormous boost in China's economic footprint.

To date, looking over the last twenty years and arriving at the present--the economies of the United States and China have acted as great complements to one another. China has proved more than able at manufacturing the physical things of this world, often at low costs no other countries can match. American consumers benefit. One average, the China price returns about $600 in savings every year to American consumers. Those who spend more, save more. In contrast, the U.S. government's recent tax cuts to individuals, designed to be an economic stimulus, returned half as much, and the country had to draw down from the treasury and add to our public debt to put that money in people's hands. China simply delivers it. So when we talk about how cheap technology transfers contribute to the Chinese low-cost manufacturing machine, we should admit that on one level Americans, and the rest of the world's consumers, benefit mightily.

First, I want to stress that I see no point in demonizing the Chinese for their own practices. They have solid reasons for doing business the way they do, and many of us would act in much the same way were we in the position the Chinese now find themselves in. Here's a simple thought experiment. Imagine you were the leader of between 1.3 and 1.6 billion people, most of them desperately poor and modestly educated. Suppose you could transfer to your people the jewels of the world's advanced industrialized nations, paying nothing for much of it and pennies on the dollar for some more. Suppose, in other words, you could steal the best technology, copyrighted materials, brand names and top entertainment for your wanting people. And imagine further that you had little expectation of being held to account for that theft. In contrast, you would be rewarded for it. In fact, that theft would make your country an ever-more desirable home for the very international fashion, technology and knowledge enterprises you were so liberally borrowing from. Anyone here would make that choice—the choice which the Chinese government and people made and still do make every day. One of the precepts of good leadership is to make one's people prosperous and capable, and the Chinese practices have followed that hands down. Remember, the incomes of the Chinese have risen four-fold in twenty years, the use of personal computers is widespread and expert and Chinese factories routinely run on the very same software that their competitors in America use. In all, China's creation of an extremely loose intellectual property regime has paid off handsomely. And, we must admit, impressively. It has been a key element of China's growth. Rather than fault the Chinese for the method of their progress, I suggest we offer admiration, grudgingly, but sincerely. Conceding their success, however, does not mean conceding. It is now time we exercise what means we have to enforce global rules that will also serve the American economy.

To understand the deep threat to the U.S., it helps to understand the mismatch between the Chinese economy and ours.

The U.S., and other rich industrialize countries, now bet our best dollars on the knowledge economy, the amorphously defined new world in which better ideas, not faster, cheaper hands, create jobs and wealth. Consider what an advanced economy like ours does best: make movies, produce television shows watched from Helsinki to Cape Town, turn out global pop stars. We design the software and processes that streamline the operations of giant retail chains and global high-tech manufacturers. We engineer advanced engines and the guts of the world's computers. We devise brands, durable corporate identities and fashions. We conjure new ways to move money and put it to work. We turn the most basic tasks into knowledge work. Modern printers, to note one example, rely heavily on the most advanced automated presses, computerized design tools and management and shipping for delivering materials efficiently to consumers and are as dependent on the latest software and technological innovations as a biotech lab. And those 2.8 million American workers who in recent years have lost their factory jobs? They don't learn new ways to use power tools. They are retrained in front of a computer; they learn to run the robots that do the jobs they used to do. You do not need to look at factory floors to see how deeply the knowledge economy reaches. Even that most ancient, and basic of all human tasks, farming, has been remade by our knowledge economy. A farmer wakes in the morning to check weather and futures prices on PC with an internet connection, he climbs into the cab of $200,000 farm machine that makes its way through the fields using GSP navigational technology. Under the wheels grow crops that are as highly engineered as the most complex pharmaceuticals, and when they are harvested they move throughout the food distribution with an efficiency made possible by tracking, inventory and sales software. One American farmer, deploying the tools of our economy, developed in public and private laboratories and workshops can do the work of 20,000 Chinese farmers. Even when we produce the physical stuff of the world, we produce it most efficiently because of the knowledge products that emanate out of the 21st century American economy.

The trouble with this apparently successful state of affairs is that the stuff we do best exists nowhere and everywhere at the same time. Some of our most valuable things -- software codes, pharmaceutical processes, car designs, digital movie files -- weigh nothing and, as e-mail attachments, can move at the speed of light. To learn American ideas and procedures is all but the same as owning them. (Unless, of course, laws successfully prohibit their co-option.) In contrast, most of what China makes that finds its way into the world market is physical. The Chinese can borrow and steal the designs to our best products all they want. The statistics are well-known to this Commission. Add them up and the Chinese economy itself looks like a counterfeit economy, one in which the vast majority of goods branded as one thing are made by someone else. Everything from simply copied commodity products such as household cleaners, fashions, consumer and business technology to goods higher up the economic and technical food chain such as biotechnology, automotive and aerospace products all have their unofficial knockoffs in China. Sometimes the copying affects only bottom lines, sometimes the stakes are much higher, as in the case false pharmaceuticals. China's drug industry is a complex mix of enterprises, some owned by the state, others private, and nearly all out of bounds of the licensing and quality control mechanisms of the world's major drug companies, whose products the Chinese copy. Copied drugs are sometimes excellent, and sometimes deadly. Both pose dangers. Bad copies kill patients, they also have the potential to kill American companies because bad drugs are now finding their way into the mix of real medicines, so that a vial of 30 pills bought at a local pharmacy in Chicago might have one or two bad pills made in a back room in Guangzhou. The patient death is bad in itself, but bad medicines also threaten American jobs and wealth. The legal repercussions may one day drive a blue chip company into bankruptcy. If that sounds far fetched consider what the recent spate of drugs removed from the market have done to the share prices and liabilities of the companies behind them.

The amount of economic activity in China tied to pirating and counterfeiting is staggering. Stolen movies and software are the poster children of global piracy and in China they are everywhere. Hollywood's Motion Picture Association estimates that 95 percent of all movies seen in China are pilfered and that its members lost $178 million in potential revenue. DVDs are only the most visible items in the pirate and counterfeit economy. Ninety percent of all software running on Chinese computers has been pirated and bought openly in stores for around $3 a copy. Using a lost-sales calculus, which measures the losses to foreign companies by tallying the value the dubious goods sold, the U.S. Department of Commerce estimates the loss to American companies at between $20 billion and $24 billion. The Department says the Japanese now lose even more: $34 billion. Add in the European Union and the number approaches $80 billion. Thomas Boam, who until recently served as the Minister Counselor for Commercial Affairs at the U.S. Embassy in Beijing, argues piracy and counterfeiting account for between 10 percent and 30 percentof the $1.4 trillion Chinese economy. Some estimates go much higher. I will explain further how these lost sales numbers undercounts the loss to the U.S. economy. We should also consider, however, how these calculations rest on a fiction, one which itself obscures the rationale the Chinese frequently offer for the intellectual property practices. In short, they argue that the real versions of the the goods they copy are simply too expensive. With drugs it is a compelling argument. The Chinese government clearly believes that providing lifesaving drugs for a fraction of their American price is in the interests of its people. With things like DVDs the argument is a bit less compelling, but price is still the issue. Few Chinese would buy genuine goods if they had to pay the prices Americans do. At $20, a DVD movie in a U.S. store equals 10 days' wages for hundreds of millions of Chinese factory workers.

And there's the rub. What Americans make and what the world values moves very easily into the counterfeit economy. If Americans wanted to borrow and steal the physical stuff that China makes, we would have to march in with an army and commandeer Chinese factories and workers. Western powers and the Japanese tried that in the mid-19th and -20th centuries, respectively, and, happily, will not repeat the experiment. China, however, can in a sense colonize the developed world simply through careful study and a willingness to go its own way on intellectual-property protection.

The most hopeful group looking at China's prospects for reform are those that study the country's growing body of laws. Quite often lawyers attend my talks on China and tell me that the country is serious about following international standards and that is volume of legal mechanism to punish transgressors is growing. They even point to some high profile cases in which international parties found some redress in Chinese courts. Yet, to an observer in the street, and to those who talk to American businesses that face China's version of enforcement, the story is not hopeful at all. Indeed, despite the proliferation of laws, the situation on the ground in China grows steadily worse. DVDs are everyone's favorite example. They are so cheap in China that foreigners are every bit as eager to buy them as locals. They also are one of the most visible exports from China's great counterfeiting machine. News laws have had no effect on the trade. Quite the opposite. The places they are sold no longer look like back-alley stalls but like Main Street retailers. Near Beijing's diplomatic row, two outdoor markets once famous for knockoff fashions have been combined into a large, bright department store-like building with escalators, tailors on site and merchants with business cards, international shipping accounts and full stocks of fake fashions, designer tableware, brand-name musical instruments and, of course, thousands upon thousands of fake Swiss watches. The most common punishment counterfeiters face is the confiscation of whatever products they have in stock. Sometimes a pitiful fine is levied. China's National Copyright Administration cites with much fanfare 52 raids on video shops in 2003, but the total fines amounted to $6,900, or an average of $132 for each offender.

With apologies to some of the other presenters at this hearing, I offer one trivial observation on the way to a more important one. It is nearly impossible to get the general public to feel sorry for Hollywood when the Chinese pirate American films and movies. Likewise, few in the world weep when big software corporations, such as Microsoft, Oracle and Adobe lose sales to pirates and counterfeiters. Yet, nearly every time one hears about the dangers of China's practices to the U.S. economy the story is told in terms of the lost sales to these sorts of companies. Missed entirely is the much bigger threat China's loose intellectual property regime poses to our whole economy. American companies are not just creators of intellectual property, they are buyers of it. It can cost millions, or tens of millions or dollars to purchase and service the software to run an American company. Yet, Chinese competitors often pay nothing for the same technology, because it is simply stolen. Walk into the vast majority of Chinese firms that run computers and one will see one work station after another stuffed with $2 version of software that costs Western competitors hundreds of dollars to run.

China's loose intellectual property rules also transfer to Chinese industry valuable intellectual assets that can take American companies years and cost significant sums to develop. American automobile makers can spend half a billion dollars developing and building anew car, and take two years to do it. As soon as the car hits the market, Chinese manufacturers study it and look at how to copy it. Chery Motors, the company which will soon introduce Chinese built cars into the U.S. market has been accused by General Motors of pirating an entire GM car and beating GM to market with the Chery copy. It is not unusual for whole assembly lines to get duplicated in China, where the copiers need not worry about the cost of developing and designing the lines. Big business in the U.S. is vulnerable, but so are smaller firms where often one good idea, patented or kept proprietary in some other fashion, is the only truly valuable asset the firm has.

China's failure to police its intellectual property rules often looks less like ineffective government than a conscious policy to shift the highest value goods from other economies into the country. It is, in essence, the largest industrial subsidy in the world, and brilliantly, it costs the Chinese nothing. In 2005, China will most likely be the world's third-largest trading nation, and counterfeiters give the country's increasing number of globally competitive companies the means to compete against powerful foreign rivals that pay for their use of proprietary technologies. In a broader geopolitical context, China's counterfeiters deny the world's advanced economies, especially in the U.S. and Japan, the opportunity to sell to China the valuable designs, trademarked goods, advanced technology and popular entertainment that the Chinese urgently desire but cannot yet produce on their own. For the U.S., this mismatch is particularly punishing. Japan and Germany, which also suffer from China's policies, do not have the huge trade deficits with China that the U.S. does. One reason is because our export economy is far more dependent on the sale highly valuable, intangible and easily copied goods. Japan and Germany make the machines China needs to run. American makes the software that runs those machines. It is far more difficult for us to paid by Chinese users for what we make, though most of the rest of the world pays handsomely for it. Until we can get paid for what we make and the Chinese use, our deficits will worsen, not improve. Say, for example, that the value of the dollar drops against the Chinese yuan. Econoists predict our trade situation will level out, but do not take into account that no matter what our goods cost, the Chinese will most likely continue to pay nothing for some of the most useful goods we make. And, as a result, their factories will continue to be able to beat even the most efficient American factories on price.

We now have a golden moment in which we can still use our power as China's most important customer to enforce a change in its intellectual property regime. Action ought to be forceful and unequivocal. Our trade deficit with China alone—not counting the rest of our trade with the country—is more than ten percent of the entire Chinese economy. That is an astonishing figure, and in it we can find strength to exert rules over our trade with China. That may require a radical rethinking of past agreements, some brinksmanship with quotas and tariffs and other remedies. Without action, however, the U.S. is likely to find our entire economy copied in China and Americans paid little for the brainwork imported to make it run.

Thank you.

Contact Information:

Ted C. Fishman
(New York Times Magazine, Money Magazine, Harper's Magazine, Esquire, USA Today)

5314 South Hyde Park Blvd.
Chicago, IL 60615-5715
USA

office: 773-643-8107
mobile: 773-968-8117
email: playfish@aol.com
URL: www.chinainc-book.com