



Statement before the Senate Caucus On International Narcotics Control

On

“Stopping the Poison Pills: Combatting the Trafficking of Illegal Fentanyl from China”

Action on Fentanyl: Learning from the rest of the US-China economic relationship

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I write as a China researcher with limited knowledge of the damaging social impact of opioid use here. For Sino-American relations, halting illegal drug trade and improving oversight of legal drug trade is an underrated issue as compared to the attention given to the trade balance and protection of intellectual property. Chinese production practices indicate the danger to American citizens, even from legal drug trade.

The Communist Party has failed to properly safeguard public health at home and undoubtedly has the capacity to curb large-scale export of illegal drugs to the US. It has intentionally or unintentionally decided these actions are not worth their costs. The American response should include diversification in the supply of pharmaceutical ingredients. The US should negotiate with China, but only for the sake of concrete changes and with the ability in hand to apply sanctions if these changes do not occur in a reasonable time.

Bilateral Economic Issues (briefly)

The headline issues in the US-PRC economic relationship at present are the trade balance, Chinese infringement of American intellectual property, and the use of tariffs to address both. These have obscured important topics, at least one of which is relevant to legal and illegal drug trade: the central role of the state in many sectors of the Chinese economy.

Bilateral trade balances are typically not meaningful. The bilateral deficit has expanded since President Trump took office¹ but this is not primarily due to worse behavior by China. Instead, the US has created more private wealth than the PRC over this period. The Federal Reserve estimates the net worth of American households rose \$8.1 trillion from the middle of 2017 to the middle of 2018. Credit Suisse puts the most recent annualized increase in private Chinese wealth at less than one-fourth of that, \$1.7 trillion.² With Americans getting richer, faster, they are naturally more likely to buy Chinese goods and services than the reverse.

Moreover, conventional figures for trade balances miss the effect of supply chains. The principal component of this is the full value of consumer electronics exports being attributed to the PRC when the value added within China is only a fraction of the final sales price of a cell phone or laptop. Chinese firms are also important in the global (legal) drug supply chain. It is difficult to calculate value-added across large trade relationships but a now-outdated estimate puts the true US trade deficit with China one-third smaller than reported in 2011.³ A smaller bilateral trade deficit, as conventionally measured, should not be a high-priority objective.

Chinese intellectual property (IP) infringement does bring real harm to the US. The biggest American comparative advantage in trade is innovation, not just in advanced technology but in all goods and services where small tweaks can win customers. Frequent Chinese disregard of patents and trademarks, theft of trade secrets, and coerced technology transfer undermine

¹ <https://www.census.gov/foreign-trade/balance/c5700.html>

² https://www.federalreserve.gov/releases/z1/20180920/html/introductory_text.htm and <http://publications.credit-suisse.com/tasks/render/file/index.cfm?fileid=FB790DB0-C175-0E07-787A2B8639253D5A>

³ <http://www.nber.org/papers/w16426> and https://www.oecd.org/sti/ind/tiva/CN_2015_China.pdf

American gains from trade and the idea of comparative advantage more broadly.⁴ This explains a good portion of American public dissatisfaction with what looks on the surface to be voluntary exchange across the Pacific.

Unfortunately, the US government response to IP infringement has not been sensible. Across-the-board tariffs retaliate against the guilty and innocent alike. No administration has devoted the time and resources needed to document Chinese behavior and target those benefiting from IP theft and coercion. The focus should be on the benefits accrued to large state-owned enterprises, (SOEs) because they are the Communist Party's chief economic tool. When foreign firms "contribute" technology to the PRC, private Chinese companies may gain but SOEs inevitably gain. Large-scale cyber-attacks, such as that which destroyed Canada's Nortel,⁵ can only occur at the sufferance of the Chinese government and always see trade secrets transferred to SOEs.

Not surprisingly, SOEs are the direct cause of another major problem in Sino-American economic relations: lack of market access. Claims of 1.4 billion customers and the world's largest market are false when large portions of the market are closed for the sake of ensuring SOEs thrive. As many as two dozen major sectors of the Chinese economy are required by long-standing policy, backed by both administrative and financial support, to be led by SOEs.⁶ No foreign competitor has been able to change that, nor has any international agreement.

As a general matter, the pervasiveness and anti-competitive nature of SOEs are why some free traders are willing to endorse protectionist measures directed at China. The core WTO principle of reciprocity offers justification for the US to respond by closing off large parts of our economy to Chinese competition. This would be excessive, but reciprocity also justifies less drastic steps, such as policies which limit legal Chinese pharmaceuticals and effectively diversify supply.

Legal Pharma Trade

The trade balance is an accounting result; IP infringement can seem abstract. There are also entirely tangible problems in bilateral economic relations that should be addressed by the US, including inadequately regulated or illegal imported drugs arriving from the PRC. Two, related risks are Chinese preeminence in global drug production and the disinterest of the Chinese government in protecting public safety at home, much less in the US.

Trade often pivots on the availability of substitutes. For instance, a 10-percent tariff with limited substitutes for the affected products will have more impact than a 25-percent tariff with easy substitutes available. If we do not simultaneously hamper imports from other countries, the vast bulk of what the US imports from the PRC can be substituted for easily.

However, there are goods for which America does depend on China. Rare earth elements, some used in military equipment, win headlines but they are not alone. Lobbying for exemptions from American tariffs being applied to imports from the PRC was based partly on the inability of

⁴ http://ipcommission.org/report/IP_Commission_Report_Update_2017.pdf

⁵ <https://www.wsj.com/articles/how-china-systematically-pries-technology-from-u-s-companies-1537972066> and <https://www.zdnet.com/article/nortel-hacking-attack-went-unnoticed-for-almost-10-years/>

⁶ <http://www.aei.org/wp-content/uploads/2015/02/Making-the-new-normal-meaningful.pdf>

firms in widely varying sectors to substitute for Chinese supply. An example is barite, used in oil and gas drilling, where approximately half of American imports come from China.⁷ Such goods would be vulnerable to any export ban imposed by Beijing in the current trade dispute.

While obscure mineral shortages would be a problem for companies, common drug shortages would be a problem for ordinary people. The PRC is by far the world's single largest producer and exporter of active pharmaceutical ingredients, closing on 40 percent of global output. It is thus critical to the drug supply chain even if it is not responsible for final products. As an illustration, Chimna is for the moment (due to a plant shutdown in Texas) the top supplier to the US of the common painkilling ingredient ibuprofen, as well as acetaminophen/ paracetamol.⁸ Chinese firms dominate the vitamin C market, to the point where they face anti-trust charges here. The firms' defense against these charges: their government told them to break US law.⁹

Lack of diversification is a standard trade challenge but the vitamin C case, and Chinese economic policy in general, points additionally to a pernicious state role. The issue in pharmaceuticals in particular is less one of commission than omission: lack of oversight of production leading to sometimes deadly quality control failures. Oversight is expensive, especially in terms of sales lost if problems are found. There are frequent cases where China's national and local governments have effectively declined to protect their own people.

The most recent headline concerned vaccines, with at least 250,000 bad doses being sold to treat standard childhood diseases earlier this year. Less than five years before that, a toxic hepatitis B vaccine killed eight infants. And five years before that, hundreds of thousands of children were sickened by milk formula adulterated with the industrial chemical melamine.¹⁰ Obviously the Communist Party did not want to face millions of frightened parents again and again, yet the state's regulatory apparatus has remained inadequate despite the incentive for improvement.

The US has been affected by this failure. The melamine adulteration killed thousands of American pets. Far worse, in 2008 a toxic ingredient was added to production of the blood-thinner heparin in China, leading to dozens of deaths and hundreds of adverse reactions in the US alone. While that was a decade ago, there are signs that progress since has been uneven. The Food and Drug administration warned five Chinese pharmaceutical manufacturers about substandard practices in 2014, but 22 in 2017.¹¹

The context in which the US faces illegal drug shipments from the PRC therefore features the Chinese state interfering in the economy when it deems suitable, including to block American

⁷ <https://fas.org/sgp/crs/natsec/R41744.pdf> and <https://www.wsj.com/articles/u-s-reliance-on-obscure-imports-from-china-points-to-strategic-vulnerability-1537781400>

⁸ <https://www.lpinformationdata.com/paracetamol-market-report/chemical-material.html> and https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/609425/Item_10_2017-OB-05_International_Strategy.pdf

⁹ <https://www.jdsupra.com/legalnews/in-re-vitamin-c-supreme-court-rules-99750/>

¹⁰ <https://www.nytimes.com/2018/07/23/world/asia/china-vaccines-scandal-investigation.html> and <http://www.cnn.com/2009/WORLD/asiapcf/01/22/china.tainted.milk/>

¹¹ <https://www.gpo.gov/fdsys/pkg/CHRG-110hrg53183/html/CHRG-110hrg53183.htm> and <https://www.ft.com/content/38991820-8fc7-11e8-b639-7680cedcc421>

exports, yet finding strong oversight of pharmaceuticals not to be suitable. In areas where the US is dependent on China-based production, the administration and Congress should consider ways to increase trade with other partners. For example, India is also a major supplier of active pharmaceutical ingredients. Additional resources to exchange information with and verify the production sites of Indian companies would be a helpful safeguard against bad Chinese practices.

Illegal Drugs And American Choices

China has the world's biggest population, of course, and small amounts of illegal export are to be expected. It appears, however, that the PRC's role in illegal fentanyl shipments is considerable. While data on unlawful activity is obviously difficult to gather, the US in 2016 identified China as the location of over half of all global producers of certain fentanyl precursors. China could thus be indispensable in mass fentanyl production. Moreover, its exports are not limited to the US. The European Center for Drug Monitoring describes most "new" (as of June 2018) shipments of fentanyl entering Europe as originating from the PRC.¹²

The dimensions of the problem and status of Sino-American cooperation are matters for relevant US government offices. Any solution must start with some sort of baseline. For example, there have been public claims that 90 percent of world fentanyl production is located in the PRC. But there does not yet seem to be much evidence that the figure is both precise and current.

For now, one vital point is clear: unlike some countries which are sources of illegal narcotics, China has the capacity to tightly limit output and shipment if the Communist Party desires. For the sake of protecting SOE's, production is controlled from energy to tobacco. Even large private entities are quickly unwound if Beijing insists, as has occurred in part with HNA and Wanda and in whole with CEFC.¹³ If China does not act, it's because action is not worthwhile for the Party.

Further, talking alone will not change this. The US has an (understandably) terrible track record convincing the PRC that policies which are in our interest are also in theirs. The Chinese central government has declined for years to pay the necessary costs to properly protect its own citizens against harmful drugs; it is certainly not going to act decisively to protect American citizens because the US demands meetings or sends new documentation.

To win sustained Chinese cooperation, the US must have a stick, while a carrot would be helpful. Both are available through China's rising share of global pharmaceutical trade and investment. The PRC's Chamber of Commerce reports export of "Western medicines" reached \$35 billion in 2017. In addition, Chinese investment in foreign medical companies has jumped the past two years (see table), while overall Chinese investment around the world has dropped.¹⁴ More legal trade and investment both justifies stringent American demands for cooperation with regard to quality control and law enforcement and offers more reason for Beijing to accept these demands.

¹² <https://www.wsj.com/articles/u-s-asks-u-n-to-class-two-chemicals-used-to-make-fentanyl-as-controlled-substances-1476469235> and <http://www.emcdda.europa.eu/system/files/publications/8870/2018-2489-td0118414enn.pdf>

¹³ <https://www.caixinglobal.com/2018-07-04/quick-take-hna-chairman-dies-in-accident-101292337.html>

¹⁴ <http://usa.chinadaily.com.cn/a/201802/09/WS5a7d00d4a3106e7dcc13bbde.html> and <https://www.cnn.com/2018/09/28/chinas-overseas-investment-drops-for-the-first-time-on-record.html>

Table: Highlights of China's Global Pharmaceutical M&A

Date	Acquirer	Target	Amount	Share	Country
March 2016	Humanwell Healthcare	Epic Pharma	\$280 million	50%	U.S.
January 2017	Sanpower	Dendreon	\$820 million	100%	Canada
September 2017	Ping An	Tsumura	\$240 million	10%	Japan
October 2017	Fosun	Gland Pharma	\$1.08 billion	74%	India
January 2018	Creat	Biotest	\$1.15 billion	90%	Germany
May 2018	Luye	AstraZeneca	\$540 million	(licensing rights)	U.K.
June 2018	CDH and Grand Pharma	Sirtex	\$1.43 billion	100%	Australia

Source: <http://www.aei.org/china-global-investment-tracker/>

In this light, some form of decertification is an obvious stick. Chinese municipalities and provinces can be deemed areas of unsafe production if they do not cooperate on fentanyl with US law enforcement. American regulators should publish such information to inform business partners as well as third countries, especially those seeing Chinese acquisitions in pharmaceuticals. With regard to legal export, Chinese companies can be classified as risky investors if quality control cannot be verified. If failure to comply is extensive, regions or companies can be barred from trade or investment with the US. Other countries may follow.

Unless the PRC's failings in drug production or export are nearly uniform across regions and companies, American sanctions should be targeted, not universal. Better-run provinces and firms should enjoy uninhibited commercial exchange, otherwise they will lose the incentive to continue their superior practices. It will not be easy to gather the needed information to identify better and worse actors and Congress can show its commitment to addressing this problem by granting the resources required. In the meantime, known egregious violators can be cited.

This raises the diplomatic issue of singling out the PRC, which the Chinese government treats as anathema. It is reasonable for the Trump administration to negotiate before naming bad actors, but the US must have a coercive tool or Beijing will (again) stonewall. China will in turn want compensation for regulatory and enforcement steps it has to now refused to take, so the administration should also have a concession in hand. The concession could take the form of a limited delay in action with regard to fentanyl or involve another issue in the broad relationship.

Trade tension between the US and China plainly complicates such talks but halting bad drug exports will not be nearly as painful for Beijing as shrinking the state sector or curbing the many forms of IP infringement. Making progress on this problem is a low bar that an acceptable economic partner must clear.